MANAGED INVESTMENT SCHEMES: AN INDUSTRY REPORT

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Centre for Corporate Law and Securities Regulation
The University of Melbourne
2003

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CONTENTS

Index of Tables and Figures

Tables

Figures

Introduction*

This research report is divided into three parts:

- Part 1: Structure and operation of the Australian managed investments industry;
- Part 2: The Australian regulatory regime in the context of international principles; and
- Part 3: Observations and conclusions.

Part 1 of the report sets out the size and scope of the managed investments industry in Australia, measured by both data from the Australian Securities and Investments Commission ('ASIC'), the Australian Bureau of Statistics ('ABS'), the Australian Stock Exchange ('ASX'), Axiss Australia and ASSIRT. The practical operation of the industry is assessed through an analysis of surveys completed by and interviews conducted with industry participants.

Part 2 of the report examines the operation of the Australian legislation, including the associated licensing regime, in light of international principles for the governance of collective investment schemes.

Part 3 contains concluding observations on the adequacy of the governance structures under Australian law.

The managed investments industry is regulated primarily by chapter 5C of the *Corporations Act 2001* (Cth). This chapter was introduced into the law by the *Managed Investments Act 1998* (Cth) ('*MIA*'), which commenced operation on 1 July 1998.

The *MIA* marked a radical shift in the policy of regulating collective investment schemes. Under the pre-*MIA* approach, schemes were operated by a management company and monitored by an external independent trustee. The trustee was under a statutory covenant to protect the interests of investors. The *MIA* abandoned this two-party system, principally on the basis that it created uncertainty as to which party was ultimately accountable to scheme investors. The *MIA* installed a regime under which there is a single responsible entity ('RE'). The legislative intention behind the 'single responsible entity' was to have one entity accountable to scheme investors.

In brief, the regulatory regime installed by the *MIA* includes the following features:

- All schemes which offer interests in themselves must be registered with ASIC (unless they fall within one of a limited number of exceptions).
- All registered schemes must be operated by a licensed public company (the 'single responsible entity'), which is subject to statutory duties of care and diligence and to act in the best interests of investors.
- Each scheme must have a constitution, a compliance plan (which must deal adequately with conflict of interest scenarios and be audited by an independent

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* The research assistance of Matthew Lees in the preparation of this report is gratefully acknowledged.

auditor) and an external compliance committee (or, alternatively, a board at least half of which must be external directors), who must monitor the RE's compliance with the law.

The Turnbull Review

In December 2001, Mr Malcolm Turnbull handed down his report titled *Review of the Managed Investments Act 1998*[1] which was commissioned by the then-Minister for Financial Services and Regulation, the Hon Joe Hockey. A summary of the recommendations of the *Turnbull Review* is contained in Appendix 6.

This research report was prepared independently of the *Turnbull Review*. The final contents of this report have taken into account the findings and recommendations of that review. However, we have endeavoured to cover different ground to that considered in the *Turnbull Review*. Nevertheless, some degree of overlap is inevitable.

In December 2002, the Parliamentary Joint Committee on Corporations and Financial Services published the results of its inquiry into the *Turnbull Review* in a report titled *Report on the Review of the Managed Investments Act 1998*. A summary of the recommendations of the report is contained in Appendix 7.

The recommendations of the *Turnbull Review* and the Parliamentary Joint Committee on Corporations and Financial Services have not have been implemented by the Government at the date of publication of this report.

The aim and focus of this report

The principle focus of this report is an examination of the managed investments industry in Australia and the means by which it is regulated. The report examines in particular:

- the different size and types of schemes in Australia;
- the extent to which the Australian regulatory regime conforms with international principles for the regulation of collective schemes;
- the legislative intention and practical operation of compliance committees;
- the internalisation and centralisation of the compliance function;
- the degree to which scheme operators or responsible entities outsource their activities and responsibilities; and
- whether the governance and regulatory approach of the *MIA* represents an improvement to the pre-*MIA* regime.

The analysis has utilised data that is publicly available as well as interviews and surveys conducted with compliance managers, ASIC representatives, compliance committee members and directors. Where appropriate, the report quotes direct speech from persons interviewed in order to illustrate the practical operation of the managed investments industry and the participants' interpretation of their role.

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1 Malcolm Turnbull, *Review of the Managed Investments Act 1998* (2001) ('*Turnbull Review*').

Interviews (both face to face and by email) were conducted with 20 persons. The total number of responses received from our written surveys of compliance managers and compliance plan auditors was 36.

The aim of this report is principally to examine aspects of the managed investments industry that have not been the subject of any detailed consideration or research. Although all aspects of the governance structure of managed investments regulation and operation are considered (to various degrees), this research report does not specifically address compliance plans or the costs of compliance. Compliance plans were not specifically addressed because ASIC itself released a substantial series of commentaries on compliance plans in March 2000. The costs of transitioning to and complying with the *MIA* were not addressed empirically in this report due to an absence of sufficient and reliable data, though some comments and observations are made in Part 1.8.

It is hoped that the contents of this report will significantly add to the growing body of knowledge and information on managed investments in Australia.

Part 1: The structure and operation of the managed investments industry

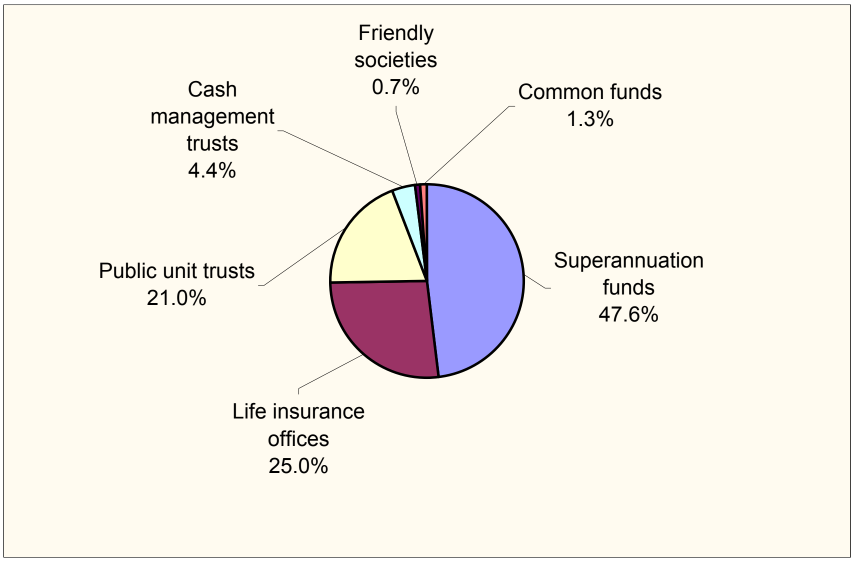
1.0 The funds management industry as a whole

The Australian funds management industry comprises a number of segments, including superannuation, life insurance, public unit trusts, friendly societies and common funds.

Table 1: The managed funds industry (September 2003)

Managed funds	Assets ($million)[2]	Percentage of total consolidated assets
Superannuation funds	319,717	47.6%
Life insurance offices	167,545	25.0%
Public unit trusts	140,983	21.0%
Cash management trusts	29,660	4.4%
Friendly societies	4,530	0.7%
Common funds	8,965	1.3%
TOTAL consolidated	671,401	

Figure 1: The managed funds industry in Australia (September 2003)



The overwhelming majority of Australian managed investment schemes are structured as public unit trusts.[3] Cash management trusts, although not classified as public unit trusts for ABS purposes, invariably take the form of managed investment schemes.

[2] ABS, *Managed Funds, Australia*, Product No 5655.0, September 2003.

[3] For the purposes of the following ABS statistics, a public unit trust is defined to mean an arrangement (fund) which:

(a) is governed by a trust deed and is administered by a management company, which under the Managed Investments Act [1998], is the single responsible entity for both

1.1 Public unit trusts and cash management trusts

Public unit trusts can be further classified on the basis of their investment asset base. The following table[4] indicates the relative size (measured in terms of assets) of Australian public unit trusts:

Table 2: Public unit trusts (March 2003)

Public unit trusts (March 2003)	Assets — unconsolidated ($million)
Equity	74,439
Property	53,671
Mortgage	5,222
Other unlisted trusts	20,790
TOTAL unconsolidated	154,122

1.1.1 Equity trusts

An equity trust is a form of unit trust in which unitholders' funds are invested primarily in a portfolio of shares of companies listed on Australian and foreign stock exchanges.[5] The size of Australian equity trusts is indicated in the following table:[6]

Table 3: Equity public unit trusts

	June 2001 ($million)	March 2003 ($million)
Listed equity trusts	5,052	11,296
Unlisted equity trusts	59,172	63,143
TOTAL	64,224	74,439

1.1.2 Property trusts

Property trusts are a form of unit trust in which unitholders' funds are invested primarily in a portfolio of real property, usually industrial, retail, commercial, residential and/or recreational properties within Australia. The size of Australian property trusts is indicated in the following table:[7]

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investment strategy and custodial arrangements (previously the latter function had been the responsibility of the trustee);

(b) is (or has been) open to the public within Australia, for the purpose of investing pooled funds of unitholders (ie investors) to yield returns in the form of income and/or capital gains; and

(c) allows unit holders to dispose of their units within a relatively short period of time, by either selling them on the Australian Stock Exchange (ASX) or back to the management company.

ABS, *Public Unit Trusts*, Product No 5645.0.40.001, March 2003.

ABS statistics on public unit trusts *do not* include cash management trusts (which are the subject of a separate publication: see below n 13), trusts that do not provide redemption facilities (such as most agricultural and film schemes) and trusts that have not sought or do not seek to raise funds from the general public, and so are not required to register as managed investment schemes under ch 5C of the *Corporations Act 2001* (Cth).

[4] ABS, *Public Unit Trusts*, above n 3, table 1.

[5] Ibid.

[6] Ibid.

[7] Ibid.

Table 4: Property public unit trusts

	June 2001 ($million)	March 2003 ($million)
Listed property trusts	41,762	50,997
Unlisted property trusts	1,811	2,674
TOTAL	43,573	53,671

Unlike all other types of unit trusts, the size of *listed* property trusts far exceeds the size of *unlisted* property trusts. This is consistent with ASX data, which indicates that approximately 68% of all listed trusts are property trusts.[8]

1.1.3 Mortgage trusts

Mortgage trusts are unit trusts which invest unitholders' funds primarily in a portfolio of mortgages over industrial, retail, commercial, residential and/or recreational properties within Australia. The size of Australian mortgage trusts is indicated in the following table:[9]

Table 5: Mortgage public unit trusts

	June 2001 ($million)	March 2003 ($million)
Unlisted mortgage trusts	5,749	5,222

1.1.4 Balanced funds

Balanced funds (or multi-sector funds) are unit trusts under which unitholders' funds are primarily invested across a number of types of investment (such as property, equities and mortgages), thus preventing them from being given a more definitive classification for statistical purposes. The ABS amalgamates these balanced trusts with trusts which specialise in particular investments (such as public securities, gold etc). The size of these 'other unlisted trusts',[10] which are predominately balanced trusts, is as follows:

Table 6: Other unlisted public unit trusts

	June 2001 ($million)	March 2003 ($million)
Other unlisted trusts	24,495	20,790

1.1.5 Cash management trusts

The ABS defines a cash management trust as

> a unit trust which:
> (a) is governed by a trust deed;
> (b) is open to the public; and
> (c) generally confines its investments (as authorised by the trust deed) to financial securities available through the short term money market.[11]

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[8] See below Figure 5.
[9] Ibid.
[10] See above Table 2.
[11] ABS, *Cash Management Trusts, Australia: Data Report*, Product No 5635.0.40.001, October 2003.

In lay terms, a cash management trust (or 'CMT') may be defined as:

> a pooled investment vehicle for investors who would not individually have access to the professional money market. By pooling funds from various sources, larger volumes of higher yielding short-dated securities can be purchased and the resulting higher returns can then be returned to trust members. CMTs generally restrict themselves to negotiable instruments [such as bank bills] of a duration of no longer than six months. As these securities are highly liquid, a CMT can accommodate cash flows, both in and out, on a daily basis, thereby offering small investors a flexibility not present in a traditional fixed rate term deposit.[12]

The size of the Australian cash management trusts segment is indicated in the following table:[13]

Table 7: Cash management trusts

	June 2000	October 2003
Number of CMTs	30	28
Assets ($million)	24 776	29,725

1.2 Number and classification of responsible entities and schemes

ASIC's database of REs, and the schemes which they operate, provided a landscape of the managed investments industry from a regulatory perspective. The information obtained from ASIC is based on information as at 31 January 2001. The data was primarily drawn from both documents that are required to be lodged when registering a scheme and ASIC's own research.

The two principal documents are:

- Form 5100: *Application for registration of a managed investment scheme*;[14] and
- Form 701L, M, N & O: *Application for a Licence as a Dealer: Responsible Entity or IDPS Operator*.[15]

The database provided by ASIC was complete in some aspects, but incomplete in others. The following information was obtained for all schemes:

- the name and Australian Company Number ('ACN') of the RE;
- the name and Australian Registered Scheme Number ('ARSN') of the registered scheme;
- the principal State of business; and
- the industry sector of the RE.

The following information was obtained for many but not all schemes:

- the total funds under management of the RE (ranges);

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[12] Australian Financial Review, County Investment Management and John Fairfax Publications Pty Ltd, *Dictionary of Investment Terms* (5th ed, 2000).
[13] ABS, *Cash Management Trusts*, above n 11.
[14] ASIC, *Application for Registration of a Managed Investment Scheme*, Form 5100 (2001). The application must be accompanied by a copy of the scheme's constitution and compliance plan: *Corporations Act 2001* (Cth) s 601EA(4).
[15] ASIC, *Application for a Licence as a Dealer: Responsible Entity or IDPS Operator*, Form 701L, M, N & O (now superseded by eLicensing).

- the compliance auditor;
- whether the scheme was using a compliance committee (yes/no);
- the custody relationship (external, related or self-custody); and
- the custodian's name.

It is not clear why the data provided by ASIC was incomplete for these categories. The funds under management, custody relationship and custodian name must have been disclosed as part of the RE's application for a dealers' licence. The details of the compliance plan auditor must be stated in *Form 5100*, and the existence (or otherwise) of the compliance committee could be identified from the compliance plan, which must accompany the lodgement of *Form 5100*.

Table 8: Information collected from the different databases

Information collected from the RE database	**Information collected from the registered scheme database**
• ACN of RE • Name of RE • Number of registered schemes • Industry sector of RE • Retail size/value of assets • Total funds under management • Ownership structure • Classification of ultimate holding company • Compliance plan auditor • Whether using a compliance committee • Custody relationship • Custodian name • Auditor of RE	• ACN of RE • Name of RE • ARSN • Name of scheme • Size of scheme • Principal State of business • Industry sector of RE • Total funds under management of RE • Compliance plan auditor • Whether using a compliance committee • Custody relationship • Custodian name • Auditor of RE

As at 31 January 2001, there were 454 REs in Australia, operating 2530 registered schemes.[16] The number of REs can be broken down as follows:

- 66 REs each operate 10 or more registered schemes.
- 47 REs each operate between five and nine schemes.
- 341 REs each operate less than five schemes.

[16] The statistics provided by ASIC to the Centre for Corporate Law and Securities Regulation ('CCLSR') differ from those statistics provided by ASIC to the *Turnbull Review*. ASIC, *Submission by Australian Securities and Investments Commission: Review of the Managed Investments Act 1998* (2001) app 2.1 indicates that:

- At 31 January 2001, there were 405 REs operating 2475 schemes.
- At 30 June 2001, there were 431 REs operating 2778 schemes.
- At 30 August 2001, there were 441 REs operating 2827 schemes.

Figure 2: Schemes operated by responsible entities

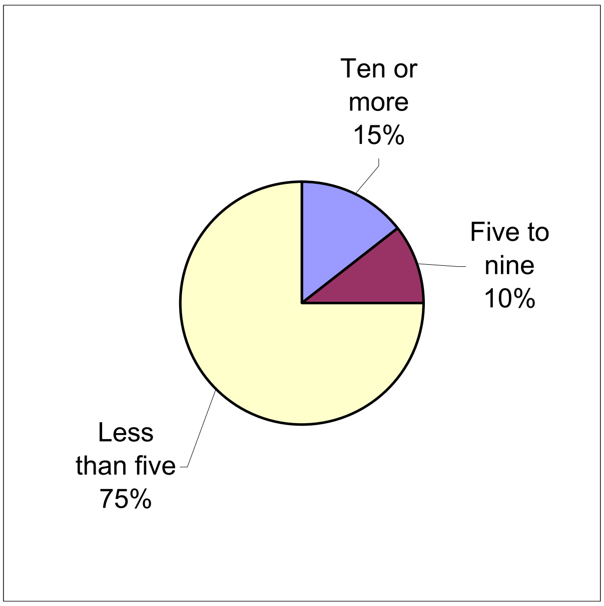


Table 9 gives the ratio of schemes to REs across the different types of schemes:[17]

Table 9: Scheme to responsible entity ratio

	Schemes	Responsible entities	Scheme to responsible entity ratio
Masterfunds	1	1	1 : 1
Film	9	3	3 : 1
Timeshare	5	5	1 : 1
Investor Directed Portfolio Service ('IDPS')	15	6	2.5 : 1
Other	7	7	1 : 1
Strata	41	13	3.2 : 1
Property	240	72	3.3 : 1
Mortgages	94	73	1.3 : 1
Primary production	217	112	1.9 : 1
Financial assets	1901	162	11.7 : 1
TOTAL	2530	454	

The following two pie charts classify REs and registered schemes according to industry sector:

The discrepancies in the data relate principally to the number of REs. The discrepancies were most likely caused by inaccurate data provided by ASIC to the CCLSR, and double counting for REs that have changed their name (with both the old name and new name each counted for the one RE). The findings and conclusions in this report are based upon the data provided by ASIC to the CCLSR. The discrepancies do not materially affect the general conclusions of this report.

[17] ASIC, *Application for a Licence as a Dealer*, above n 15, sets out a list of 'kind and sub-category' of scheme. The 'financial assets' category includes cash management trusts and equity and fixed interest trusts, and schemes that invest in interests in managed investment schemes. Primary production has nine sub-categories, including viticulture, forestry and cattle breeding.

Figure 3: Responsible entities sorted by industry sector

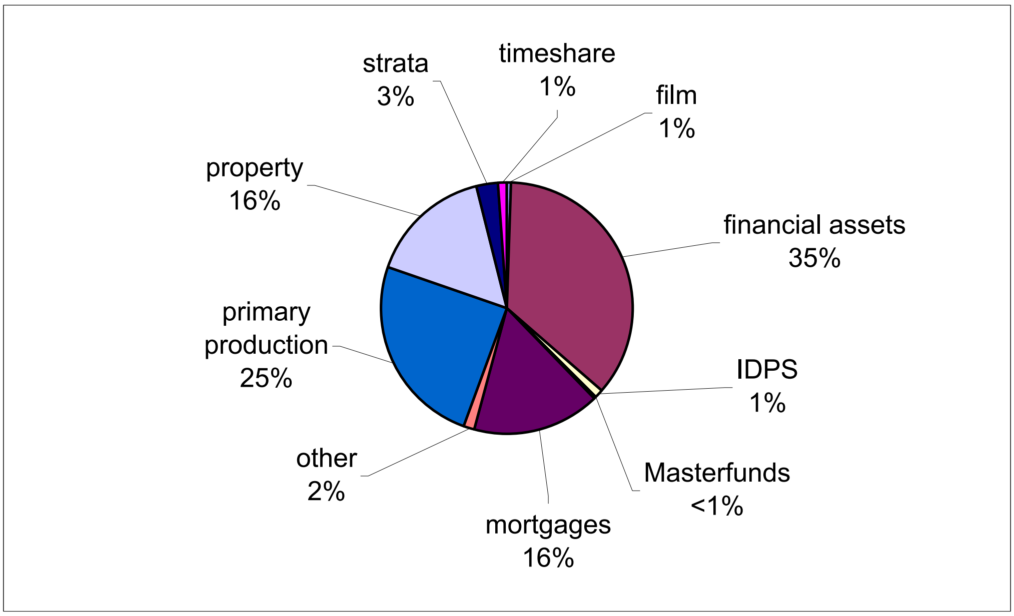
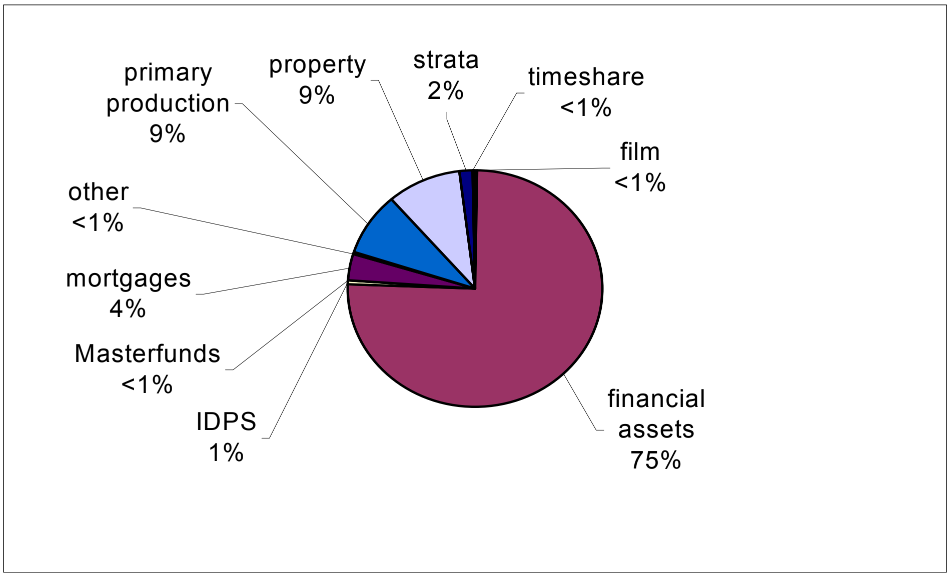


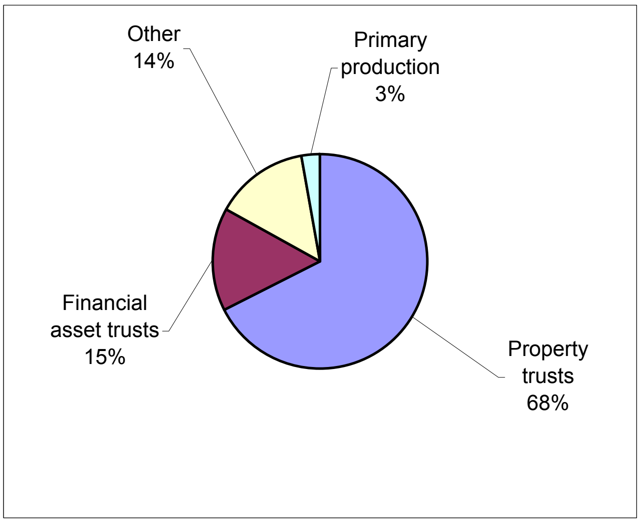
Figure 4: Registered schemes sorted by industry sector



1.3 Listed schemes

Data extracted from the ASX website (http://www.asx.com.au) indicate that there were 71 listed trusts on the ASX as at 30 September 2001. The vast majority of these listed trusts are property trusts, followed by financial asset trusts. The 'other' category includes oil/gas, casinos/gaming, leisure activities and mining.

Figure 5: Listed trusts by number



Listed property trusts also dominate the property trust industry when measured in terms of assets under management.[18]

1.4 Funds under management

According to ASIC, 76 REs manage funds in excess of $250 million, 52 between $50 million and $250 million, and 152 less than $50 million. The sizes of the remaining 174 REs are not known. Data on the number of employees in each RE was unavailable.

An Axiss Executive Briefing notes that the retail managed investments[19] industry is concentrated at the upper end, with the top five investment managers accounting for 52% of the total assets of the managed investments industry.[20]

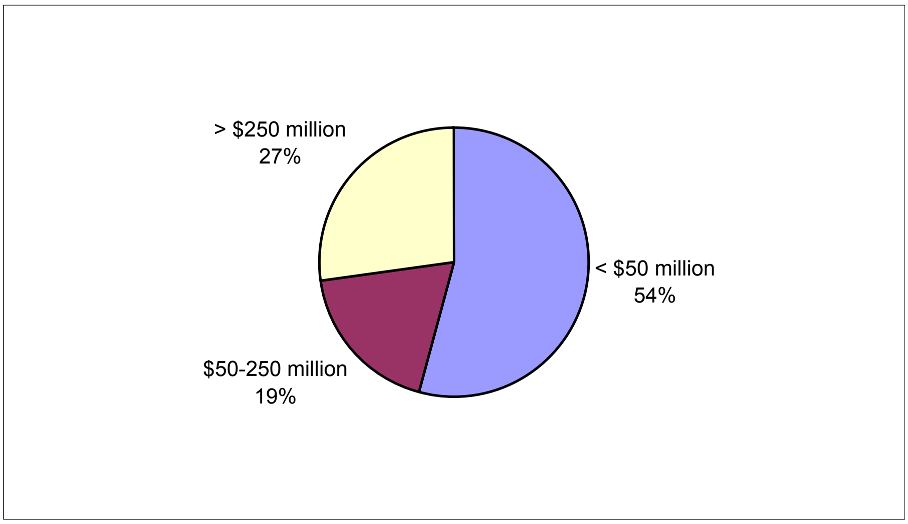
Table 10: Funds under management

Funds under management	< $50 million	$50–250 million	> $250 million	Unknown	TOTAL
Number of responsible entities	152	52	76	174	454

Figure 6 represents the percentages of REs classified according to funds under management:[21]

[18] See above Table 4.
[19] Here, the phrase 'managed investments' is defined to include public unit trusts and cash management trusts as measured by ABS data: see above n 3.
[20] Axiss Australia, *Investment Management in Australia* (2001) 12.
[21] Figure 6 is based on data where funds under management is known. Therefore, the sample size is 280. The number of responsibilities for which funds under management unknown is 174. Appendix 1 provides a breakdown according to industry sector.

Figure 6: Funds under management per responsible entity



1.5 Ownership structure

Of the 454 REs, the ownership structure could be traced for 175. Ultimate ownership of the REs can be classified as follows:[22]

Table 11: Ownership structure

Ultimate owner	Number of responsible entities	Percentage
Privately held	41	23%
Bank (Australian)	30	17%
Bank (foreign)	21	12%
Listed public company	21	12%
Integrated financial services (Australian)	15	9%
Integrated financial services (foreign)	13	8%
Unlisted public company	9	5%
Financial planning/asset management (foreign)	8	5%
Financial planning/asset management (Australian)	6	3%
Real estate/construction company (foreign)	4	2%
Real estate/construction company (Australian)	2	1%
Research company	2	1%
Australian government	2	1%
Shareholders of related entity	1	1%
TOTAL	175	100%

Axiss Australia points out that a notable feature of the retail managed funds industry over the past decade has been the rationalisation (in the sense of concentration) of fund managers.[23] This has occurred due to the desire of banks to 'gain greater exposure to industry growth by purchasing market share in order to offer a more

[22] Appendix 2 provides a breakdown according to industry sector.
[23] Axiss Australia, above n 20, 11.

competitive range of financial services and capitalise on their existing distribution channels'.[24]

The same Axiss report notes that banks have also been very active in buying into the financial planning industry, stating that, of the 12,700 financial planners who comprise the top 100 dealer groups in Australia, almost 30% work in bank-owned groups and furthermore that banks now own 12 of the top 20 dealer groups in Australia.[25]

1.6 Compliance committees

The compliance committee is intended to serve as a 'monitoring and reporting intermediary' between the area performing the primary compliance function and the board of the RE.

The requirement to establish a compliance committee under s 601JA of the *Corporations Act 2001* (Cth) is a function only of the relative proportion of 'external directors'[26] on the RE's board; it is not a function of the nature of the scheme type operated by the RE or the funds under management of the RE.[27]

Where a compliance committee is required to be established, it must have a minimum membership of three persons, the majority of whom must be external members.[28] The rules relating to 'externals' are intended to promote independence in the decision-making and review functions of the compliance committee.

Chapter 5C of the *Corporations Act 2001* (Cth) is premised on the regulatory basis that 'one size fits all'. To accommodate this approach, the laws are drafted at a very generic level, particularly in relation to the requirements concerning compliance committees. The legislation does not specify any particular governance requirements as to the appropriate size of these committees (except as to the minimum number of members), meetings, procedures or the appointment and retirement process. Instead, these matters are left to the discretion of the RE, who must detail them in the scheme's compliance plan.

The following findings of compliance committee use were determined on the basis of data indicating affirmatively that the scheme operates either using a compliance committee or not using a compliance committee.[29]

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[24] Ibid.

[25] Ibid, quoting Money Management, *Top 100* (2000).

[26] Defined in *Corporations Act 2001* (Cth) s 601JA(2).

[27] A compliance committee must be established under the Act if less than half of the directors of the RE are external directors. The RE must establish a compliance committee for *each* scheme operated by it. Therefore, while the requirement to have a compliance committee is defined by reference to the composition of the RE's board of directors, the committee itself is scheme-specific rather than RE-specific.

[28] 'External members' are defined in s 601JB(2) of the *Corporations Act 2001* (Cth).

[29] Of the 2530 schemes recorded as being registered with ASIC, it could not be determined for 802 (31.6%) whether or not those schemes operated using a compliance committee as envisaged by Pt 5C.5 of the *Corporations Act 2001* (Cth). Consequently, the sample size was 1728 schemes. The analysis of compliance committees in this section proceeds on the assumption that these 'unknowns' are occurring

Based on ASIC data, of the 1728 schemes that comprised the sample, 85.7% of all schemes used a compliance committee. The high degree of prevalence of compliance committees may indicate that the boards of most REs are comprised of persons, only the minority of whom would be classified as "external directors" under s 601JA(2).[30]

The results concerning the use of compliance committees can be broken down according to:

(1) funds under management of the RE;
(2) scheme type; and
(3) funds under management and scheme type.

Table 12 gives the break down according to the funds under management of the RE:[31]

Table 12: Compliance committee use

Funds under management	< $50 million	$50-250 million	> $250 million	Unknown
Percentage using compliance committee	87.7%	98.2%	86.4%	76.7%

These figures suggest that the proportion of 'external directors' on the boards of REs do not vary considerably with the size of the RE, where size is measured by funds under management.

Based on ASIC data, property schemes use compliance committees in 93.5% of cases, followed by financial asset schemes (84.9%), primary production (81.0%) and mortgages (78.2%).[32] There would appear to be no definitive correlation between compliance committee use and scheme type.

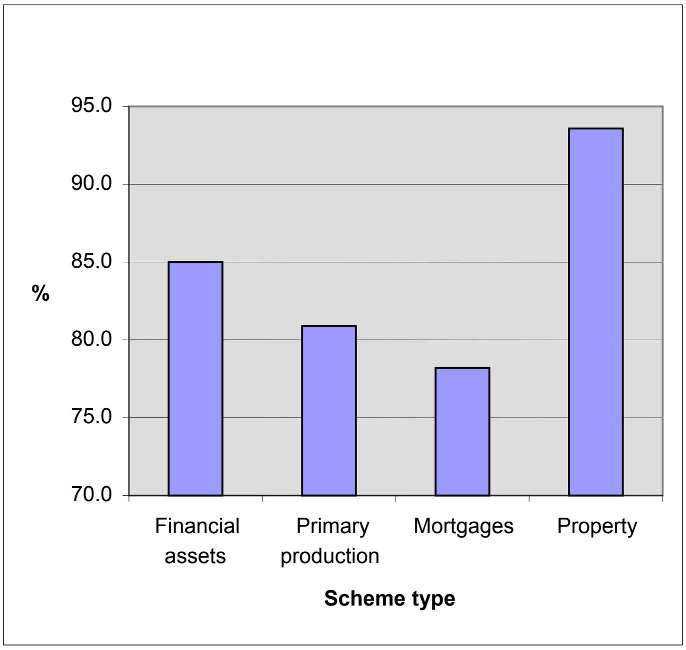
in the same percentages as the known data ie 85.7% 'using compliance committee' and 14.3% 'not using compliance committee'. For the full data, see below Appendix 2.

[30] However, this should be qualified by saying that some REs are likely to use a compliance committee (or equivalent) irrespective of whether they were obligated to do so.

[31] Although our source data only recorded funds under management of the RE, not the scheme, we have classified funds under management in the table according to scheme. For example, the total number of schemes (which either affirmatively did or did not have a compliance committee) which were operated by REs having funds under management of less than $50 million was 277. Of that number, 243 had a compliance committee. The calculation 243 divided by 277 translates into 87.7%.

[32] The remaining scheme types (strata, other, investor directed portfolio service ('IDPS'), timeshare, film and masterfunds) were not analysed as the sample size was too small from which to draw inferences.

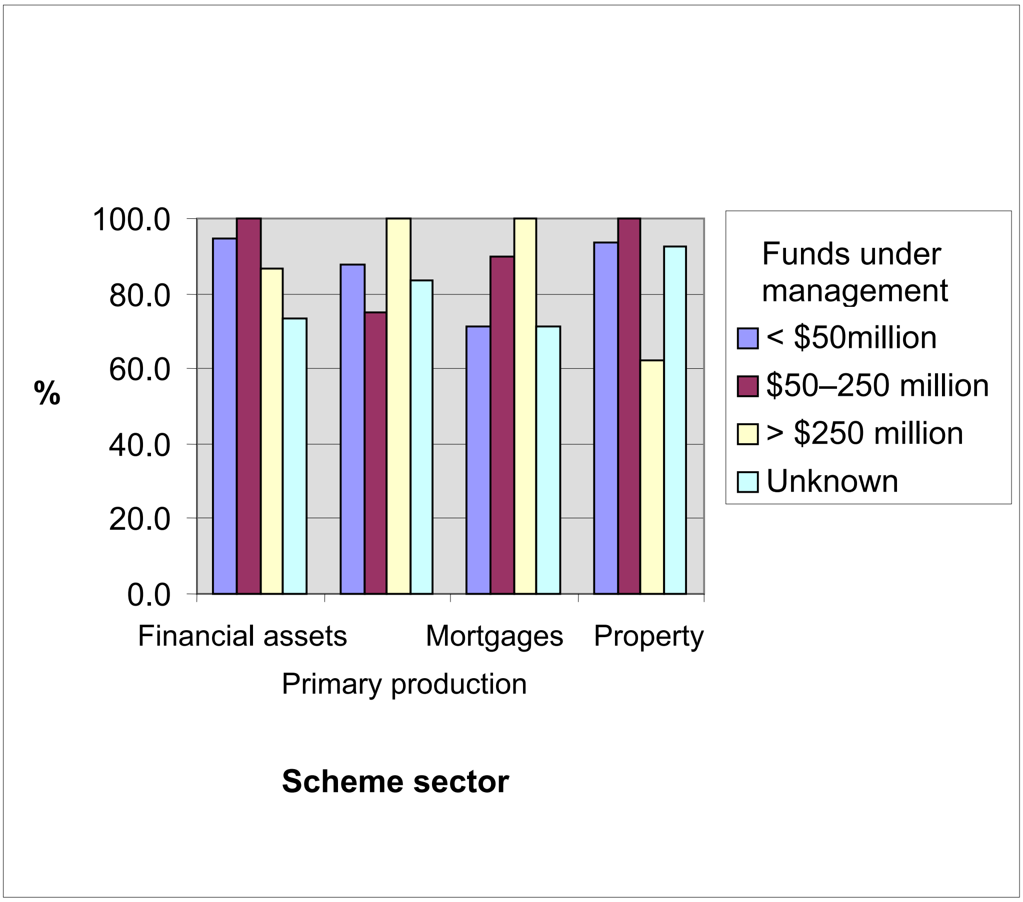
Figure 7: Percentage of schemes using compliance committee



The following figure represents these scheme sectors broken down according to funds under management of the scheme:[33]

[33] Although our source data only recorded funds under management of the RE, not the scheme, we have classified funds under management in figure 7 according to scheme. For example, the total number of financial asset schemes (which either affirmatively did or did not have a compliance committee) which were operated by REs having funds under management of less than $50 million was 58. Of that number, 55 had a compliance committee. The calculation 55 divided by 58 translates into a 94.8%.

Figure 8: Compliance committee per scheme sector



The 'Funds under management unknown' indicates that no information could be obtained concerning funds under management.[34]

1.6.1 Functions of the compliance committee

The committee is charged with certain functions, which may be broken down into three categories:

(1) monitoring;

[34] To appreciate the significance (or otherwise) of 'funds under management unknown':

Scheme sector	Number of schemes with funds managed by responsible entity unknown	Total number of schemes in sector	Percentage unknown
Financial assets	575	1901	30.2%
Property	40	240	16.7%
Primary production	101	217	46.5%
Mortgage	21	94	22.3%
Strata	17	41	41.5%
IDPS	5	15	33.3%
Film	6	9	66.7
Other	1	7	14.3
Timeshare	5	5	100

(2) assessment and recommendation; and
(3) reporting.

Under the monitoring function, the compliance committee must 'monitor' the RE's compliance with the scheme's compliance plan. Under the assessment and recommendation function, the compliance committee is required to 'assess' at regular intervals whether the compliance plan is adequate.

There are two strands to the compliance committee's reporting function: (i) reporting to the RE; and (ii) reporting to ASIC.

The compliance committee must report to the RE:

- on whether the RE complies with the scheme's compliance plan;
- on the adequacy of the compliance plan and make recommendations where considered necessary;
- any (actual or suspected) breach of the *Corporations Act 2001* (Cth) involving the scheme; and
- any (actual or suspected) breach of the provisions of the scheme's constitution.

With reference to the last two bullet points, it is important to note that the reporting function extends to *any* breach; the significance or materiality (or otherwise) of the breach does not determine its reportability, indicating that the compliance committee has no discretion in this respect. The legislation, perhaps unjustifiably, works from the assumption that every breach (no matter how technical) of the scheme's compliance plan or constitution or the Act may jeopardise the interests of scheme investors. The downside of not qualifying breaches according to materiality is that it has the potential to create a 'checklist environment', which may obscure consideration of major compliance risks or breaches. Compliance for the sake of compliance should not be the guiding principle.

The compliance committee must also report to ASIC where the committee is of the view that the RE has not taken, or does not propose to take, remedial action to deal with actual or suspected breaches of the Act or the scheme's constitution as reported to the RE by the compliance committee. This requirement implies that the board of the RE has some sort of reporting obligation back to the compliance committee.

As the discussion in the following section shows, the compliance committee is *not* the primary compliance organ/s of the RE. There are other primary compliance organs that ordinarily report to the committee or, more commonly, to a compliance manager, who then reports to the compliance committee.

The functions of monitoring, assessment and reporting

Our research aimed to identify the practical approach taken by compliance committees in order to discharge their statutory functions, in particular:

- their interpretation of the requirement to 'monitor' the RE's compliance with the compliance plan;
- how, and at what point, the compliance committee becomes aware of breaches;

- follow-up procedures dealing with breaches; and
- the regular assessment of the adequacy of the compliance plan.

The clear picture that emerges is that the vast majority of compliance committees in practice are substantially relying on information feeds provided by the area performing the primary compliance function. Generally, the monitoring function of compliance committees does not manifest itself in practice in the monitoring of the day-to-day operations of the RE, but more in the nature of an 'after the event' review of those operations.

Our survey results indicate that compliance committee meetings are most commonly held on a quarterly basis (73%), followed by bimonthly meetings (14%) and monthly meetings (13%).

The frequency of formal compliance committee meetings as compared with formal board meetings indicates that the compliance committees meet either as frequently as the board (41%) or less frequently than the board (36%). It was not common to find the compliance committee meeting more frequently than the board (9%).[35] These results suggest that the compliance committee operates in a similar vein to a board subcommittee, such as an audit committee or remuneration committee. To this extent, the practical operation and ability of compliance committees to protect the interests of scheme investors is limited.

The responses received to the question of the degree of oversight that is necessary in order for a compliance committee to discharge its 'monitoring' obligations, ranged from:

… complete and exclusive reliance on reporting lines from the primary compliance function:

> *... It is the [compliance manager's] role to keep [the compliance committee] informed.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 34 financial asset schemes.

> *The RE is very pro-active and observes a high standard of reporting on all areas of compliance to the committee, and therefore, the committee has few opportunities to be pro-active.*
>
> Compliance Manager of a RE with funds under management of less than $50 million, operating nine primary production schemes.

> *Compliance committee receives comprehensive report from compliance officer every quarter outlining exceptions.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating one financial asset scheme.

> *The Committee monitors RE activities by reviewing quarterly checklist that certain activities have been performed in accordance with the compliance plan.*

[35] The remaining 15% indicated that the board met 'as required' as compared with the compliance committee which met on a quarterly basis, therefore not enabling relative frequencies to be established.

Compliance Manager of a RE with funds under management of between \$50–\$250 million, operating six property schemes.

To date the compliance committee has relied on certifications as to compliance from the compliance manager, operational investment staff, service providers and auditors of service providers.

Compliance Manager of a RE with funds under management of between \$50–\$250 million, operating five financial asset schemes.

... My view is totally. But that is different to ASIC's view. I think that ASIC is taking a stand to try and extend the role [of the compliance committee] past what was originally laid out in the legislation ... The compliance officers do all the checking and monitoring and reporting — that's their role — if they don't do some of those things or that bit of the system breaks down, the compliance committee ensures that they do their monitoring, reporting and whatever in line with the compliance plan .. and the licence and licence conditions ... [Take] the three month forward cash flow figure — if the compliance committee thought it was their role to monitor the 3 month forward cash flow figure then why would the chief financial officer bother doing it? ... If the compliance committee then come along ... and say okay now I want to audit this, talk me through it — I just don't think that's a great way of fostering the right compliance culture in an organisation. [But] there is nothing wrong with tabling that at a meeting or even including it with the compliance committee [meeting] papers.

Professional independent compliance committee member.

… to substantial reliance with a slightly broader focus:

Detailed report from compliance officer plus random checking of investor and loan files.

Compliance Manager of a RE with funds under management of between \$50–\$250 million, operating three mortgage schemes.

Bimonthly meetings where they receive regular reports from Compliance, Business Risk and Internal Audit. As well as presentations by business areas and external auditors.

Compliance Manager of a RE group with funds under management of greater than \$250 million, operating 25 financial asset schemes and 14 property schemes.

Reliance on compliance function — with regular input from operational areas and service providers.

Compliance Manager of a RE with funds under management of greater than \$250 million, operating 12 financial asset schemes.

… to a more pro-active and creative role:

The compliance committee 'drill down' into the operational areas covered in the compliance plan. A rolling checklist is maintained to record what has been covered. Staff from within the business come and present and show audit trail documentation.

Compliance Manager of a RE with funds under management of greater than \$250 million, operating 21 financial asset schemes.

> *The committee regularly interviews staff in relation to procedures required by the compliance plan and undertakes an advisory role in relation to updates of the compliance plan and makes suggestions as necessary.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 45 financial asset schemes.

> *We take a very pro-active management approach to our audit and compliance committee in that the reporting that goes through is highly detailed ... not just specific resolution-based [reports] which they are requested to deal with in certain larger issues. They receive reports from a number of sources, obviously from myself as compliance manager on all the ongoing day to day breaches but they are specified to a very high detail with summaries of trends given at the end of the reports just so that they can act as executive summaries behind the whole detail.*
>
> Compliance Manager of a RE with funds under management of between $50–$250 million, operating seven schemes (a mixture of financial assets, property and mortgages).

Some respondents saw a very small role for the Committee:

> *The Committee relies on the compliance manager reporting all breaches to the committee. The compliance manager has daily interaction with operations managers and their staff and is in the best position to 'monitor' compliance by the RE.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 23 schemes, both financial assets and IDPS.

Others seem to view the functions of the compliance committee as a quasi-audit role:

> *[The compliance committee] tests the veracity of issues when required.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 16 primary production schemes.

Our research indicates that the compliance committee becomes aware of breaches of the scheme's compliance plan and constitution and the *Corporations Act 2001* (Cth) primarily through the reporting structure of the compliance manager and his or her team and, to a far lesser extent, the auditor of the compliance plan.

Invariably, *standardised* compliance and breach reports are used as part of the reporting structure. Escalation procedures — where material breaches are notified immediately to the compliance committee, with other breaches being reported periodically — are commonly used in practice.

In a number of cases, it was clear that there were reporting lines both from the compliance committee to the board (as expressly required by s 601JC(1)(b) of the *Corporations Act 2001* (Cth)), and from the board back to the compliance committee (as implied by s 601JC(1)(c)).

In relation to the question of how the compliance committee becomes aware of breaches, and the procedures that are followed to remedy the breaches, the following sample of responses are noted:

Compliance Manager reports serious material breaches immediately to the committee chair. All breaches are included in the compliance manager's report.

Compliance Manager of a RE with funds under management of greater than $250 million, operating 23 schemes (both financial asset and IDPS).

Formal report presented by Compliance at CC [compliance committee] meetings. Significant breaches are reported to the Chair when they occur. Compliance will report on the breach and rationale for treatment and required reporting. The CC will review this and seek input from external auditor if required.

Compliance Manager of a RE group with funds under management of greater than $250 million, operating 25 financial asset schemes and 14 property schemes.

We have a breaches policy with procedures for escalation. 'Material' breaches are reported to the Committee and the board immediately ... Other breaches are reported quarterly. Each breach is discussed in detail and someone from the area which had the breach will often attend [the compliance committee meeting] to explain/discuss. If there is a follow-up point, it will be minuted on an 'action list' which forms part of our standard minute format.

Compliance Manager of a RE with funds under management of greater than $250 million, operating 21 financial asset schemes.

The compliance officer keeps the register of breaches, which is circulated prior to each [compliance committee meeting] ... Procedure to be followed is:

1. *Compliance officer reports breach to compliance committee (CC) and responsible entity (RE). Recorded in register.*
2. *Compliance officer requests RE to attend to breach. Copy to CC.*
3. *If RE does not attend to breach, compliance officer will advise CC. If no action taken, CC will advise ASIC.*

Compliance Committee member for a RE with funds under management of less than $50 million, operating one primary production scheme.

Standardised checklist which is reviewed quarterly and 'flags' breaches ... [The procedure for dealing with breaches is as follows] ... Identify breach. Committee makes recommendation to board to rectify and identify procedural amendments if necessary. Board reports back to compliance committee on outcome.

Compliance Manager of a RE with funds under management of between $50–$250 million, operating six property schemes.

Compliance officer reports to committee through quarterly reporting and exception report. Auditor also provides a quarterly report to the committee. The compliance officer follows up breaches and reports remedial action to committee.

Compliance Manager of a RE with funds under management of greater than $250 million, operating one property scheme.

[Standardised] compliance breach reports; [the compliance committee] would be alerted immediately rather than wait until next formal (quarterly) meeting .. Monitor action taken by management/board to deal with breach (through written/verbal reports), assess its adequacy, make further recommendations if appropriate and monitor implementation.

Compliance Manager of a RE with funds under management of greater than $250 million, operating three financial asset schemes.

> *Reports from compliance officer and records from the breaches register ... report to board with request for board to report back with details of action taken and remedial steps.*
>
> Compliance Manager of a RE with funds under management of less than $50 million, operating one mortgage investment scheme.

> *Material issues notified immediately by compliance head [to compliance committee] and formally at meeting. Immaterial issues raised at regular meetings.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 12 financial asset schemes.

> *Once again, it depends on the type of breach. If it was a material and adverse breach of our compliance plan or our dealer's licence or a material breach in terms of reimbursement to a party, they [the compliance committee] would get notified by telephone and told of it straight away. I [compliance manager] would then prepare a paper that would go to them that would set out exactly what had occurred and what action we were taking, etc — so they would be notified immediately. In addition, at each meeting a regular agenda item is compliance breaches for the period, and I prepare a report that sets out the date of when it occurred, what funds were involved ... and what action we're taking to ensure that the breach doesn't re-occur ... The committee gets every breach, they don't just get what we deem to be high risk breaches, they get all breaches.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 15 financial asset schemes.

The committee's role is an 'after the event' check, with most breaches being reported to the committee well after the breach has occurred and well after the breach has been subsequently remedied. In cases where significant or material breaches occur, it is usual for at least one person of the compliance committee (usually the 'internal member') to be informed of the breach immediately.

A further function of the compliance committee under s 601JC(1) is to 'assess at regular intervals whether the compliance plan is adequate'. This raises two questions: how does industry view the term 'regularly' and what is involved in this 'assessment' process?

Our research indicates that most compliance committees are formally assessing compliance plans on an *annual* basis: annual assessment (50%), quarterly (18%), bimonthly (9%), monthly (9%), needs basis (9%) and ad hoc assessments (5%).

Although the compliance plan is reviewed as a matter of course on an annual basis, certain changes or events would be expected to trigger a review outside of the scheduled annual review. These triggering events could include a restructure within the RE, the engagement of a new external service provider or the establishment of a new fund, etc. Furthermore, a number of respondents mentioned that the compliance plan was reviewed more frequently during the first 12 months of operation of chapter 5C of the *Corporations Act 2001* (Cth).[36]

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[36] ASIC released three sets of commentary on compliance plans in March 2000, 21 months after the commencement of the *MIA*, but three months before schemes were required to transfer to the *MIA* regime: ASIC, *Commentary on Compliance Plans Received by ASIC: Financial Asset Schemes* (2000);

Some endorsed the legislative approach of allowing the RE to determine the need for a regular review:

> *Regularly — they've [the compliance plans] been reviewed once. At the next committee meeting we're going to propose a project for their review again. But once in two years, and they will be formally reviewed once and they will be reviewed again over the next six months … I wouldn't be in favour of saying every 12 months for example … [In our case] it will be longer than 12 months, but the business changes. But I don't think anyone should come and review an entity and question why it has not been reviewed in 12 months. It may be that within the statutory framework you don't change too much about what you do. Rather than going through the motions, it is better to ask the question 'has anything changed about the way we do business' … Whereas this is a much more evolving business and for example if we were to outsource something immediately you would have to look at the plan and query whether it suits the nature of the business anymore.*
>
> Compliance Manager of a RE with funds under management in excess of $250 million, operating approximately 50 registered financial asset schemes.

The nature of the responsibilities imposed on the compliance committee would seem to require that the compliance committee have a reasonably in-depth knowledge of the compliance plan of the scheme. Our research indicates that compliance committees have input into the formulation and amending of the compliance plan at either a macro 'big picture' level (46%) or a macro and operational 'day-to-day' level (36%).

Some comments were as follows:

> *It would only really be reviewed about once a year. We are currently reviewing the compliance diary and which to be frank, we look at more than the actual compliance plan … [which is] because the diary is actually cross-referenced to the compliance plan. Basically [our auditors] went through the plan, pulled all the things that we needed to do and at what time of the year.*
>
> Compliance Manager of a RE with funds under management of less than $50 million, operating one property trust (overseas properties).

> *The finance director [also a compliance committee member] had a fair bit [of input into the compliance plan], but apart from that not a lot … All of the directors of the RE read it and gave their comments, etc. But there was not a lot of direction from them.*
>
> Compliance Manager of a RE with funds under management of less than $50 million, operating one property/development scheme.

> *[The compliance plan] is a living document and it also comes down to how it's actually written — what scope is actually in there. If you've got a very detailed plan obviously you may need to review it more regularly. Some of the plans that I've seen are quite general … I would find it hard to believe that an RE hasn't amended their plan in a twelve month period … What will generally happen is that if I [compliance manager] amend it, I will give them [the compliance*

ASIC, *Commentary on Compliance Plans Received by ASIC: Property Schemes* (2000); ASIC, *Commentary on Compliance Plans Received by ASIC: Agricultural Industry Schemes* (2000).

> *committee] a marked up version of it and say … this is what I want to change it to, these are my reasons why and this is the monitoring process that will go in place along side with it. What they [the compliance committee] do is basically review that amendment and if they believe that it is in order they will make the recommendation that the amended plan be put to the [RE] board for approval … I would like to think that they have a micro understanding of the plan and the processes. I give them all the documentation.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 15 financial asset schemes.

> *Changes [to the compliance plan] proposed by management are submitted to the compliance committee for review, comment and approval for recommendation to the directors.*
>
> Compliance Manager of a RE with funds under management of between $50–$250 million, operating five financial asset schemes.

1.6.2 Locating suitable candidates for membership

Our survey and interview results suggest that REs have had no or little difficulty in obtaining suitable, 'independent' candidates: 77% of respondents indicated that they had 'no difficulty', 23% had 'some difficulty' and no respondents indicated that they had 'extreme difficulty'.

Almost invariably, compliance committee candidates are sourced from industry contacts and existing networks, particularly persons known to the senior management and directors of the RE, or on the recommendations of auditors and lawyers. Search and location costs were negligible. On no occasion were external recruitment firms used to locate suitable candidates.

Similar to the growth of the professional non-executive director, there is evidence to suggest that compliance committee membership is becoming a professional occupation, predominately sought by retiring partners of law firms or accountancy practices.

One interviewee, who is a member of multiple compliance committees across a number of REs, commented on the size of this growing professional market:

> *There are all the retired accounting partners, because they have also have to go at 55 — minus sometimes — and that is a good pool. There are all the lawyers who retire as early as they can, back off from their partnership duties and ease up the accelerator and then there are all the ex-fund managers floating around the place, and plus there is a big pool now of people who have a bit of compliance experience and lots of compliance people have left their large organisations and are now freelancing as well … I know that people who come along to the [compliance committee] forums who aren't on compliance committees and they've been coming along for two years … [It's] quite clear they're hunting for positions … I just think there are heaps of good prospects who aren't even on compliance committees yet.*
>
> Professional independent compliance committee member.

Another professional compliance committee member said:

> *In the main the people with whom I act on the compliance committees are ex-corporate trustees. My organisation, which consists of myself, a consultant solicitor and two admin support staff, primarily deal in compliance matters. We act as compliance committee members but where we fail to satisfy section 601JB(2) of the Corporations [Act] we provide the compliance officer and if required, carry out the administrative function.*
>
> Professional independent compliance committee member.

In one respect, this is a positive result as it indicates that, at least in the context of establishing and maintaining compliance committees, the costs of transition to the *MIA* were not onerous. On the other hand, the relatively informal approach by which compliance committee members are accessed (existing networks and word of mouth) does give the impression of a loosely affiliated club or pool of candidates, which could tend to compromise genuine independence.

1.6.3 Tenure of membership

For those participants that were interviewed, all indicated that compliance committee members were on standard 'term engagement' contracts, ie engaged for fixed periods ranging from two to three years, with a right of renewal after expiration of the term and with standard notice periods. A reflection of the majority of views was:

> *Most people [compliance committee members] are appointed for two years with effectively a one to three month termination period by either party. That seems to be the regular thing. There doesn't seem to be any concept that compliance committee members should be rotated on a regular basis like a board when you retire by rotation.*
>
> Professional independent compliance committee member.

The large pool of candidates, coupled with the relatively insecure tenure of compliance committee membership — the terms of office of compliance committee members are determined exclusively by the RE, with neither ASIC nor scheme investors having any power to approve or remove compliance committee members — could be viewed as having the potential to compromise their independence.[37] This is because there is at least the potential for 'committee shopping' by the RE. According to one industry association, commenting on the lack of genuine independence of external members of the compliance committee, 'they [members of the compliance committee] are appointed by, paid by, and may be removed by the RE. Indeed, investors need not even be notified of a change'.[38] To overcome this perceived deficiency, some have called for compliance committees to consist of 'substantial, experienced and appropriately insured corporate entities', under which both ASIC and scheme investors would be consulted concerning the appointment and resignation of compliance committee members.[39]

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[37] Trust Company of Australia Ltd, *Review of the Managed Investments Act ('MIA') 1998* (2001) (a submission to the *Turnbull Review*).

[38] Trustee Corporations Association of Australia, *Submission to the Review of the Managed Investments Act 1998* (2001) (a submission to the *Turnbull Review*).

[39] Ibid.

1.6.4 Background and experience of compliance committee members

The persons comprising compliance committees are typically from either a financial/accounting background or a legal background, and to a lesser degree, from an operational (particular industry) background. Our survey results indicate that it is usually a combination of these persons that comprise the committee, suggesting that the industry perceives that the optimal mix for the committee requires a range of skills and experience.

Compliance committee members are not subject to any qualifications, training or experience prerequisites. There are also no industry standards to which compliance committee members are subject. However organisations such as the Independent Compliance Committee Members' Forum ('ICCMF') and the Association of Compliance Professionals of Australia ('ACPA') have raised awareness and facilitated the dissemination of information concerning the role of compliance committees. This awareness does, however, appear to be concentrated at the more sophisticated end of the market, with those members of compliance committees for schemes operating in remote areas (particularly agricultural schemes) having little opportunity to share the benefits of networking.[40] Compliance committee members are, however, subject to a statutory duty to exercise the degree of care and diligence that a reasonable person would exercise if they were in the member's position.[41]

While minimum standards may redress perceived imbalances in the quality of compliance committees, they might cause unjustified inflexibility:

> *I am not in favour of setting these pre-requisites because of the relative inflexibility that will come with them. For example, ASIC have imposed quite rigid standards for responsible officers and key persons of responsible entities ... I have seen these requirements prohibit people who would make excellent candidates as directors of responsible entities to be of no use to the responsible entity because of some technical exclusion.*
>
> Industry association representative and legal adviser.

Our survey results also indicate that it is common (73%) to find at least one member of the board of the responsible entity sitting on the compliance committee. The person with such common membership was more usually (71%) an executive director rather than a non-executive director. Some respondents indicated that the compliance committee was exclusively comprised of some members of the board, ie the persons occupied dual and separate roles (as opposed to the board itself taking on supervisory compliance arrangements).

The relatively high incidence of executive directors sitting on their own compliance committees is encouraging to the extent that it indicates that compliance issues are being examined by senior levels of management and that the committee's comments are being made available to the board. On the other hand, from a governance perspective, this finding highlights a risk that the independence of compliance committees may be compromised in practice by the presence of an executive director. Nevertheless, the legislation clearly contemplates that 'internal' persons are permitted

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[40] *Turnbull Review*, above n 1, [3.3.1].

[41] *Corporations Act 2001* (Cth) s 601JD(1)(b).

to sit on the compliance committee. This probably recognises that the effectiveness of the compliance committee may be better served by a person who is involved in the day-to-day, operational aspects of the scheme. If that is the underlying rationale, then there is a question whether the internal person should not be a member of the board, and instead should be either the compliance manager or officer.[42]

1.6.5 Size of compliance committees

Part 5C.5 of the *Corporations Act 2001* (Cth) prescribes the circumstances where a compliance committee is required to be established, the minimum number of members, and the number of 'independents' who must sit on the committee. There are no prescriptive rules concerning membership, except to the extent that the compliance plan must make adequate arrangements relating to the membership of the committee.[43]

Our research indicates that, in almost all cases, the number of persons forming a compliance committee is three, comprising of two external persons and one internal person. This is the minimum number prescribed by the Act. There were only isolated instances of compliance committees being comprised of four to six persons, which were reported in relation to the larger fund managers, ie operating in excess of 15 schemes and having funds under management in excess of $2 billion.

One might have expected that the number of compliance committee members would increase with the number (and diversity) of schemes operated by the RE. However, our research indicates that this is not necessarily the case. The most likely explanation for this observation is due to the centralised nature of the operation of the primary compliance organs and the compliance committee.[44]

1.6.6 Interaction between compliance area, compliance committee and board

To enable a full appreciation of the operation of the compliance committee, it is necessary to understand how it interacts with other areas within the RE. From our survey results, we have built up a profile of a typical reporting structure, both from and to the compliance committee.

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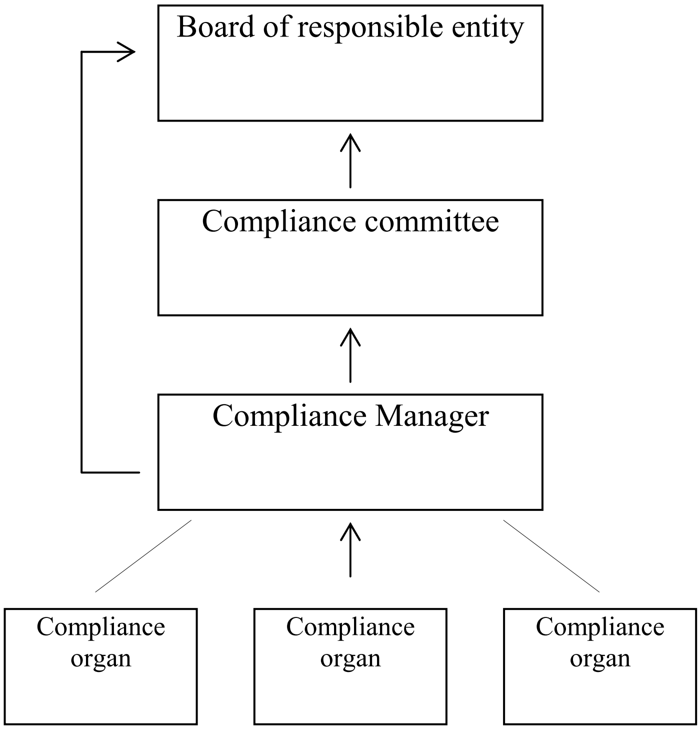
[42] The position is clouded in circumstances where the compliance manager is also a board member. This is not an uncommon scenario, particularly for smaller to medium operators.
[43] *Corporations Act 2001* (Cth) s 601HA(1)(b)(i).
[44] See below Part 1.6.7.

Figure 9: Typical reporting structure



Under this structure, the primary compliance organs invariably report to a compliance manager who in turn reports to the compliance committee, who then report to the board of the RE. Our research indicates that this linear reporting structure is often supplemented by additional direct reporting lines, most commonly from the compliance manager direct to the board (or a board member). Our survey found that, where a compliance committee was being used, in 73% of cases the compliance manager was reporting directly to both the board and the compliance committee. This is consistent with the prevalent finding of common membership of the compliance committee (the internal member) and the board. This suggests that compliance and compliance-related matters are being disseminated to board level. (However, the degree to which the board is devoting time to compliance and compliance-monitoring issues is a different question).[45]

As noted earlier, a RE need not establish a compliance committee for a scheme where at least half of the directors of the RE's board are classified as external. Under such circumstances, the legislation therefore implicitly contemplates that the compliance monitoring function is to be performed by those external members of the board. However, the *Corporations Act 2001* (Cth) imposes no specific functions or responsibilities comparable to s 601JC(1) (which applies to the compliance committee) on those persons/areas who are expected to oversee the operation and the effectiveness of the primary compliance organs of the RE.

The Act, so it seems, places great faith in the fact that at least half the directors of the RE's board are external (and thus notionally independent) and so would be expected to oversee the operation and effectiveness of the primary compliance organs. These

[45] This question is discussed below Table 13.

'external' directors are subject to statutory duties, most notably the duty under s 601FD(1) to

> (f) take all steps that a reasonable person would take, if they were in the officer's position, to ensure that the responsible entity complies with:
> (i) this Act; and
> (ii) any conditions imposed on the responsible entity's dealers licence; and
> (iii) the scheme's constitution; and
> (iv) the scheme's compliance plan.

Given the legislative intention, one might have expected to find that the amount of time spent by the board on compliance-monitoring would on average have been substantially greater in circumstances where a compliance committee was not being used. However, our survey results indicate that there is no appreciable difference. Our findings indicate that, irrespective of whether or not a compliance committee is being used, boards are spending relatively little time on compliance and compliance-monitoring issues.

Table 13: Board consideration of compliance issues

Time spent by board on compliance and compliance-related issues	0–20%	21–40%	41–60%	> 61%
Where compliance committee is being used	73%	14%	14%	–
Where compliance committee is not being used	78%	11%	11%	–

1.6.7 Compliance centralisation

Section 601JB(1) speaks of a 'scheme's compliance committee', indicating that each scheme is to have its own compliance committee. Our research indicates that the compliance committees (and primary compliance organs/areas) operate as centralised units, particularly for larger scheme operators that manage a number of investment schemes. From the RE's viewpoint, the compliance committee operates at a 'scheme operator' level, not at a 'scheme' level.

There were instances where the same compliance committee operated across a number of REs within the corporate group. In one case, three REs (all part of the same corporate group) which together operated 39 managed investment schemes (both financial assets and property schemes) were covered by the same compliance committee.

The degree of centralisation was even pronounced for those operators that merged their audit subcommittee with their compliance committee, with that merged committee approaching compliance beyond that required by the *MIA*:

> *The committee obviously has to deal with obligations that it has under the MIA with respect to each registered scheme, but the matters that they have to consider can be quite varied from a compliance perspective, and because ours is an audit and compliance committee, the issues that they discuss are wide ranging and go a long way beyond the MIA reporting requirements because other legislative requirements have a direct impact on registered schemes so it's quite varied and interrelated in many ways.*
>
> Compliance Manager of a RE with funds under management of between \$50–\$250 million, operating seven schemes (a mixture of financial assets, property and mortgages).

Similar to compliance committees, chapter 5C requires each scheme to have a compliance plan. As noted above, each compliance plan must make 'adequate arrangements' in relation to the operation of the compliance committee. The Act, in conjunction with ASIC class order relief,[46] facilitates the adoption of template compliance plans for 'those parts which have common operation across several schemes'.[47] The operation of the compliance committee would appear to be one such area.

Therefore, the centralisation of compliance committees is, to a large degree, a reflection of the centralisation of compliance plans. By requiring both compliance committees and compliance plans to operate at a scheme level rather than at a RE level could be perceived, according to one respondent, as an area where the legislation fails to reflect either practical operation or practical necessity. This respondent noted:

> *You should be able to have just one plan with a schedule ... [The Act] looks at a business like saying that every fund is a silo and it's got its own little structure. It doesn't in reality happen like that. Controls sit horizontally across your business — horizontally and vertically I guess — but the law doesn't recognise that and so you struggle. Every single plan has to be audited. ... [T]he costs of that are borne by scheme members ... They [auditors] do internal control reports. The AGS report, which is quite a comprehensive internal control document, is not fund-specific. If you are able to give them an engagement letter like that, you would get the [compliance plan audit] fee per fund to come down.*
>
> Compliance Manager of a RE with funds under management in excess of $250 million, operating approximately 50 registered financial asset schemes.

The legislative model of having scheme-specific compliance committees and compliance plans could be more easily justified where the RE operates different types of schemes. For example, a RE that operates an equity trust and a property syndication scheme could be expected to be exposed to different compliance risks and thus adopt different compliance practices. For example, the valuation of the scheme assets for the equity trust would be undertaken daily given the volatility of share markets, whereas daily valuation procedures for the property trust scheme would appear to serve little purpose. That ASIC released, in March 2000, three separate *Commentary on Compliance Plans*[48] covering financial asset schemes, property schemes and agricultural schemes is a reflection that sound compliance risks and practices vary according to the nature of the scheme, although it is noted that there are a number of areas of commonality.

Perhaps the scheme-specific attributes of the *MIA* are a safeguard against project managers or promoters of schemes using REs merely as vehicles for fundraising purposes. As one respondent observed:

> *The situation has caused me some difficulties. In WA, I act for responsible entities of single, one prospectus projects, of multiple prospectuses for the same*

[46] ASIC, *Class Order 98/50* (1998).

[47] ASIC, *Managed Investments: Compliance Plans*, Policy Statement 132 (1998) [21].

[48] ASIC, *Commentary on Compliance Plans: Financial Asset Schemes*, above n 36; ASIC, *Commentary on Compliance: Property Schemes*, above n 36; ASIC, *Commentary on Compliance Plans: Agricultural Industry Schemes*, above n 36.

> *project, of multiple prospectuses for multiple unassociated projects, and for REs who are colloquially referred to as 'plug-ins' that act as RE for project managers who do not wish to, or are unable to, obtain their own dealers licence.*
> *Given the above, I feel the compliance committee [CC] is more RE specific. This is overcome by the RE ensuring that we [the CC] are included as the CC in prospectuses, and we attend separate meetings, which run consecutively. The NTA [net tangible assets] and other matters relating to compliance with the dealers licence are discussed initially and each separate project is discussed at each relevant meeting.*
> *My personal view on this is that possibly the RE is delegating its responsibility to the project manager, which is not, I believe, within the true essence of the principles of the Act.*
> *To expand on my argument, I would give the following examples:*
> *(A) A project raises funds for the purposes of planting and harvesting eucalypts (blue gum). This may be established on one or more different parcels of land in one or more States, through one or more prospectuses. The RE is responsible for each project. The CC is appointed to the RE and an additional appointment is made for each prospectus, but for the same compliance committee members.*
> *(B) A project manager wishes to raise funds for [example] a Paulownia project but does not obtain a dealers licence. They then 'plug-in' to an existing RE with a dealers licence and the RE applies to ASIC for a variance to their licence. This may occur in a number of different cases and the RE may be appointed RE to a number of diverse projects, for which they have no relevant management expertise.*
>
> Professional independent compliance committee member.

However, even where scheme-specific compliance plans can be justified, it is more difficult to justify scheme-specific compliance committees given that the committee is intended to serve as an 'overseer' of the primary compliance organs of the RE.

Perhaps the scheme-specific aspects of compliance and governance structures stems from one of the rationales underlying chapter 5C of the *Corporations Act 2001* (Cth), that being the protection of scheme investors. From the perspective of scheme investors, a regulatory regime that requires *each scheme* to have a compliance plan and a compliance committee would appear to hold stronger appeal than a regime that imposes those requirements at a RE level. This is because scheme investors by definition invest in schemes, not in the RE, although the investment performance of the RE (and others engaged by it) ultimately determine the benefits to the investor.

1.7 Outsourcing

The use of external service providers, or 'outsourcing' as it is more commonly known, is a growing trend within the managed investments industry. This is attributable principally to two factors:

- first, the managed investment regulatory regime itself; and
- secondly, the general trend towards specialisation in all areas of commercial life.

The pre-*MIA* regime (known as the 'prescribed interests regime') that regulated unit trusts was based upon a two-party structure, under which the scheme was established under an approved trust deed, which gave certain powers and responsibilities to a management company and separate powers and responsibilities to a trustee. The management company had expertise in relation to promotion of the scheme, and typically performed the investment management function (ie research, market analysis and portfolio management). The trustee was responsible for protecting the rights and interests of the investor, and was under an obligation to exercise due diligence and vigilance in carrying out its functions and duties.[49]

The *MIA* moved away from this two-party structure in favour of a 'single responsible entity' approach. As part of the transition process, one of those two parties had to retire from their respective positions.[50] It is understood that it was predominately the management companies that assumed the role of the RE, with the trustee companies 'reluctantly' retiring from their fiduciary roles.[51] In either case, the two former separate roles had naturally led to specialisation. The 'single responsible entity' approach, being driven primarily by the need to provide greater certainty and protection to scheme investors by imposing accountability on the 'responsible entity', had worked against the natural leanings toward specialisation.

The *Corporations Act 2001* (Cth) contemplated that a specialisation outlet was necessary, and thus the rationale for s 601FB(2). Under this section, a RE is permitted to appoint an agent (related or otherwise) to do anything that the RE is authorised or required to do in connection with the registered scheme. Among other things, this facilitated trustee companies to become REs, by allowing the investment management function to be outsourced, and conversely facilitated management companies to become REs, by allowing the custody and administration functions to be outsourced.

On a very broad level, there are two key areas: (1) custody and administration; and (2) investment management. In practice, these two areas manifest themselves in the following activities:

[49] Former s 1069(1)(e)(1) of the *Corporations Law*. The obligation took the form of a covenant in the trust deed.
[50] Former ss 1455–7 of the *Corporations Law*.
[51] Constellation Capital Management, *Submission to MIA Review* (2001) 1 (a submission to the *Turnbull Review*).

Table 14: Outsourced activities

Industry uses	Relevant sections of Act
Investment and portfolio management.	
Custody of scheme property.	601FC(1)(i), 601FC(2) and 601HA(1)(a)
Valuation of scheme property.	601FC(1)(j), 601HA(1)(c)
Record-keeping — of accounting, taxation and unit registry records for the scheme.	601HA(1)(e)
Performance of income and distribution calculations, and collection and distributions of income earned from investments.	
Payment of fees to the RE and others (on appropriate requisition by RE).	601FC(1)(k)
Processing of applications, redemptions and distributions (including bank reconciliation statements).	

Respondents expressed a variety of views on benefits and dangers of outsourcing. For example:

> *Outsourcing, there's nothing wrong with outsourcing. Outsourcing the investment management function normally means you're engaging in third-party management, like National Australia Bank; they don't manage any of their money, they simply parcel it out to a series of managers and offer a 'manager of managers' type of product. There is nothing wrong with that; it is a very acceptable business model and most major banks would go that way. Custody is appropriately outsourced, rather than self-custody. I would be very reluctant to run a company that was its own custodian, just as I feel it is inappropriate to be one's own trustee.*
>
> Managing Director of an independent trustee company.

> *I believe that outsourcing is valid, however, I am aware of cases where the responsible entities have virtually outsourced every function. This is going too far. There must be some management and compliance functions retained within the responsible entity for the reason that the investors are paying for the skills the responsible entity brings to the scheme, and not its ability to supervise external agents. Outsourcing does not allow the responsible entity to exercise the same degree of control, manage conflicts of interest and respond to issues.*
>
> Representative of industry body and legal adviser.

> *Yes, outsourcing is ideal in some cases and can keep costs to a manageable level. I have found it difficult to ensure that the REs put in place the appropriate contracts, and monitor these. Delegation can be good, but in some cases there is clear abdication, which is very unhealthy.*
>
> Professional independent compliance committee member.

The degree of monitoring of external service providers perhaps represents the most significant risk associated with outsourcing. ASIC's surveillance outcomes report would also tend to suggest that inadequate monitoring of service providers is a significant problem.[52] The common picture that emerged from our interviews was one where the external service provider conducts periodic self-assessment of its performance (which is then reported to the RE), coupled with an annual review process conducted by the key executives of the RE. This type of approach is reflected in the following views expressed by respondents:

> *All external service providers are engaged by way of contract, and that's part of our due diligence process. Much of the capacity is assessed beforehand — their computer systems, disaster recovery, a whole range of factors are looked at before they are appointed. There are service level agreements and service benchmarks in place with those service providers. They typically all provide monthly reports to indicate their service capabilities to reach those particular benchmarks, with exception reports provided to myself as compliance manager and also key executives within our organisation. There is a formal annual review process and half-yearly meetings between our executive personnel and theirs.*
>
> Compliance Manager of a RE with funds under management of between $50–$250 million, operating seven schemes (a mixture of financial assets, property and mortgages).

> *We issue questionnaires to our service providers on a quarterly basis. And then once a year we'll go out and we'll audit the responses to that questionnaire.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 34 financial asset schemes.

> *We're asking for a confirmation statement of the actions that have been actioned in the portfolio. I get from the custodian a monthly report to confirm that they continue to satisfy the requirements of ASIC in respect of the custodian and the $5 million NTA, and that they have not breached the compliance plan as it applies to them through the month. I also visit each custodian annually to sit down with them and say … look at their general reporting structure, tell us how it affects us, and how you deal with our transactions in your office, what actions have you got in place for breaches, disaster recovery plans in place …*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 41 financial asset schemes.

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[52] According to ASIC, *2000–2001 Surveillance Outcomes for Responsible Entities*, Information Release 01/09 (2001) 3, inadequate monitoring of service providers topped the list (27%) as the most common type of breach of the compliance plan. Furthermore, ASIC's review of audit compliance plans indicates that the most common qualification (19%) in audit reports relates to deficiencies in the monitoring of external service providers.

> *We have an agreement in place with them. It basically lists every function that gets undertaken and what our expectations are ... We undertake a review of them — I do one on an annual basis to ensure that they comply with Policy Statements 131 and 133 ... We have weekly telephone calls with them. We also keep a log and the log basically forms the basis for the weekly telephone calls ... Senior management of the custodian meet with [our] director of operations and [our] head of client trust service on a six-weekly basis. In addition, we get half-yearly internal control reports from the external auditors and NTA calculations, certifications. Compared to others, we have a pretty robust monitoring process with our custodian.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 15 financial asset schemes.

It is observed that a system of periodic self-assessment by the external service provider, which is then reported to the RE, is a weak form of ongoing monitoring. However it is acknowledged that properly conducted and thorough site audits by key responsible officers of the RE may overcome this shortcoming. Nevertheless, there remains the inherent risk of shirking on the part of the RE, particularly where the external service provider is a related party.

It should also be noted that, although a compliance plan must set out measures relating to the supervision and monitoring by the RE of the external service provider, a compliance plan auditor is not expected to conduct an audit of these service providers.[53]

1.7.1 Custodial arrangements

The means by which scheme property is held is a fundamental issue to any jurisdiction that permits the operation of collective investment schemes. The International Organisation of Securities Commissions ('IOSCO') Principles expressly recognise the importance of the custody function,[54] requiring the custodian to be 'functionally independent' of the scheme operator and to 'act in the best interest of investors'. As will be discussed in Part 2 of this report, Australian law does not expressly observe these international guidelines.

Using ASIC data, custodial arrangements were measured across all REs for which custodial arrangements were disclosed.[55] The consolidated results indicate that the respective percentages of custodial arrangements are as follows:

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[53] Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, *Special Considerations in the Audit of Compliance Plans of Managed Investments Schemes*, Auditing Guiding Statement 1052 (2002) [38].

[54] See below Part 2.0 with regard to IOSCO Principle 2.

[55] The sample size is thus 202.

Table 15: Custodial arrangements across all responsible entities

Custodial arrangement	Number of responsible entities	Percentage
External/independent	128	64%
Self-custody	55	27%
Related party	17	8%
Other	2	1%
Total	202	100%

Our survey results indicate that of those REs that outsource the custodial function, 88% use an external independent custodian.

There are a number of possible reasons for the predominant use of 'third-party' custodians,[56] including:

- The REs do not satisfy ASIC's operational and capital adequacy criteria for custodial arrangements under Policy Statements 131 and 133.
- Even if they have the capacity to satisfy the ASIC criteria for self-custody, they choose to outsource the custodial function for commercial and/or prudential reasons.
- Inertia from the former prescribed interests regime; REs that were previously management companies have found it easier and convenient to simply re-negotiate custodial arrangements with trustee companies.

The apparent widespread use of external, independent custodians, in the absence of an express legislative or licensing requirement,[57] is a positive reflection that most of the industry holds the view that independent custodianship of scheme assets represents a model of best practice.

These results, when measured across the four largest industry sectors, yield the following trends:

Table 16: Custodial arrangements for major industry sectors

	External	Self-Custody	Related Party	Other
Financial assets	77%	9%	14%	0%
Property	78%	19%	3%	0%
Primary production	64%	24%	8%	4%
Mortgages	21%	73%	6%	0%

Table 16[58] indicates that, with the exception of REs operating mortgage investment schemes, most REs use an external custodian, ie an entity that is not commercially or legally related to it.

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[56] 'Third-party' custodial arrangements are derived by adding the percentages together for 'external' and 'related-party' custodians.
[57] The ASIC licensing regime that applies to REs in relation to custodial arrangements only draws a distinction between self-custody and third-party custody arrangements; no distinction is drawn between related party custodianship and independent custodianship.
[58] For graphs, see below Appendix 4.

The finding that most mortgage investment scheme operators, many of whom are operated by firms of solicitors, choose to adopt self-custody arrangements is most likely explainable on the basis that solicitor firms have already established facilities for dealing with trust money and for holding certificates of title as part of their practice. As one solicitor mortgage scheme operator observed:

> *We act as the custodian ourselves. Given that we are a group of solicitors with a strongroom and a deeds clerk, we find that we're dealing with mortgages and titles to properties that we're very comfortable with in any event. It doesn't present a significant problem to us in that regard. So we've not seen the need in our circumstances to use an external custodian. We have considered in most recent times the possibility of moving away from a contributory mortgage practice that has sub-schemes that an investor invests directly into, to a system that has (like a debenture company) a unitised product. We may very well be in a situation where we consider using an external custodian in that circumstance.*
>
> Compliance Manager/Solicitor of a RE with funds under management of less than $50 million, operating one mortgage investment scheme.

Nevertheless, it would seem readily apparent that self-custody and related-party custody represent a higher risk of inappropriate dealings (conflicts of interest) than arrangements that use an external independent custodian.

Furthermore, there would appear to be a positive correlation between 'third-party' custodial arrangements and the number of schemes operated by the RE.

Table 17: Custodial arrangements and scheme: responsible entity ratio

	Scheme: responsible entity ratio	Use of a third-party custodian
Financial assets	11.7 : 1	91%
Property	3.3 : 1	81%
Primary production	1.9 : 1	72%
Mortgages	1.3 : 1	27%

The positive correlation between multi-scheme operators (particularly for scheme operators of financial asset schemes) and use of third-party custodians is probably attributable to two factors. First, operational necessity. Secondly, the fact that the RE's ability to negotiate competitive rates for the use of custodial and related administrative services provided by professional custodians is greater where bulk services are being sought.

Custodian arrangements for these four largest scheme types, when measured across funds under management, indicates that

- self-custody decreases as funds under management increases;
- external custodianship increases as funds under management increases; and
- related-party custodianship increases as funds under management increases.

Table 18: Custodial arrangements and funds under management

Percentage of responsible entities[59]	Funds < $50 million	Funds $50–$250 million	Funds > $250 million
Self-Custody	35%	19%	12%
External	60%	71%	76%
Related Party	5%	9%	12%

The finding that related-party custodianship increases as funds under management increases is most likely a result of mergers and acquisitions that have resulted in a more concentrated industry.

1.7.2 Investment management

A notable feature of the managed funds industry (here, including both superannuation funds and life insurance offices and "financial asset" managed investment schemes) over the past decade has been the increasing use of specialist investment managers.[60] Axiss Australia notes that, from June 1990 to June 2000, assets placed with professional investment managers increased at a faster rate than the underlying managed funds pool.[61]

In the industry, outsourcing of the investment management function occurs at various levels, particularly in relation to financial asset schemes. At its most basic, a specialist investment manager could be engaged to make the strategic portfolio decisions for the RE. At the other end of the outsourcing scale, we have the operation of master funds or master trusts. Master fund arrangements have been described as:

> An investment vehicle that enables individual investors or small superannuation funds to channel money into one or more underlying investments — most commonly wholesale or retail pooled funds operated by professional investment managers. Master funds can generally be categorised into three distinct types: a) discretionary funds, where the individual investor selects the underlying investment product(s) from a list drawn up by the master fund manager; b) fund of funds, where the investor selects a general risk profile, eg growth, capital stable, but the master fund manager selects the underlying investments from among a range of products managed by external managers; c) feeder funds, which operate similarly to fund of funds arrangements, but with the master fund manager also being responsible for managing the underlying investments. Master funds which are structured as prescribed interests are commonly referred to as Master Trusts.[62]

Effectively, under a master fund, the investment is not directly in shares or property, for example, but in another managed investment scheme or schemes. This allows the RE to outsource the investment management function, providing investors with a range of investment managers.

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[59] The percentages in this table are based on data where both the custodial arrangement and funds under management of the RE are known. For the underlying data, see below Appendix 5.

[60] Axiss Australia, above n 20, 13.

[61] Ibid. Funds managed by specialist investment managers increased from A$154 million (June 1990) to A$549 million (June 2000).

[62] Australian Financial Review, County Investment Management and John Fairfax Publications Pty Ltd, above n 12.

In relation to managed investments particularly,[63] ABS data indicates that 77% of all assets of managed investments are placed with specialist investment managers.

Industry concentration is evident on two levels: assets under management and ultimate and associated ownership. An ASSIRT survey indicated that by June 2000, the 10 largest investment managers held approximately 60% of the funds management market, with the 20 largest holding almost 85% of the market.[64] Furthermore, as at 30 June 2000, almost 50% of funds (here, including both superannuation funds, life insurance offices and managed investments) placed with specialist investment managers were being managed by entities associated with banks, with another 30% being managed by entities associated with life companies.[65]

Our own survey research suggests that the investment management function is more commonly outsourced to entities related to the RE, or otherwise within the financial group. Of those that outsourced the investment management function, 75% outsourced to a related-party company.

1.8 Costs

The Explanatory Memorandum to the Managed Investments Bill 1997 (Cth) contemplated that there would be 'transition costs' in moving to the regulatory arrangements under chapter 5C.[66] These costs were dependent on a number of factors including the nature of the compliance arrangements that the entity needed to establish (such as the compliance plan and the compliance committee) and whether the entity chose to retain the existing trustee to hold scheme property, chose to appoint another entity to act as custodian or chose to hold scheme property itself. Those factors were stated to be difficult to quantify or estimate.

The Explanatory Memorandum, in seeking to justify the move from the two-tier structure of trustee and management company to the single responsible entity, stated that:

> the fees associated with custodial work are typically lower than the costs associated with trustee supervision. With the industry estimated to have a size of approximately $85 billion, and based on a 'typical' trustee fee of 0.08% of funds, the current two tier structure is estimated to give rise to trustees fees of approximately $68 million per annum. In contrast, if all schemes were to retain a custodian to hold scheme property (which, while not required, provides one basis for assessing cost differences), the estimated cost of those custodian arrangements would be almost $21.25 million per annum (based on a typical trustee fee for custodian services of 0.025% of funds).[67]

The Explanatory Memorandum conceded that there was to be expected a net increase in costs, but that the regulatory arrangements under chapter 5C 'will result in other benefits and efficiencies', citing unquantifiable benefits such as the removal of the

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[63] Here, the phrase 'managed investments' is defined to include public unit trusts and cash management trusts as measured by ABS data: see above n 2. The respective figures for superannuation funds and life insurance offices are 68% and 83%: Axiss Australia, above n 20, 14.

[64] Axiss Australia, above n 20, 16.

[65] Ibid 14.

[66] Explanatory Memorandum, Managed Investments Bill 1997 (Cth) [3.1]–[3.6].

[67] Ibid [3.2]

uncertainty that arises as to responsibility for the operation of the scheme and the associated costs of trustees and management companies 'second guessing each other'.

It was contemplated that ASIC would require additional resources to administer and enforce the provisions of chapter 5C, particularly during the transition period.[68] In our interview with an ASIC representative, they indicated that throughout the transition period (1998–2000), the number of persons working directly on the administration of the *MIA* was of the order of 50–60 full-time persons, with most time being devoted to the administration of the licensing regime. In its submission to the *Turnbull Review*, ASIC also indicated that it spends a 'disproportionate amount of resources' on administering those schemes that are least like traditional unit trusts (such as mortgage schemes and strata schemes).

Participants in the managed funds industry, particularly those that operate financial asset schemes,[69] use a standard formula for measuring the costs of operating a managed investment scheme. The formula is known as the management expense ratio ('MER'). According to Investment and Financial Services Association ('IFSA') Standard 4.00:

$$\text{MER} = \frac{(\text{fees} + \text{recovered expenses} - \text{input tax credits}) \times 100}{\text{average scheme size}}$$

'Fees' include management fees (excluding up-front and exit fees), trustee fees, custodian fees, and audit fees. The costs of compliance would ordinarily be bundled into this item.

To the extent that compliance costs are factored into management/trustee/custodian fees and have been fully passed on to investors, empirical results suggest that industry compliance costs have *decreased* since the introduction of the *MIA*.

A KPMG report commissioned by IFSA found that from 1 July 1998 to 30 June 2000, there has been an overall decline of 2% in the total weighted average MER; a reduction that translates to an annualised cost saving of approximately $26.8 million.[70] The KPMG report was based exclusively on an examination of financial asset schemes, by far the largest sub-industry which, according to the empirical results found in Part 1 of this research report, comprises 35% of all REs and 75% of all registered schemes.

However, these results must be examined in light of the limited scope of the KPMG report. Being limited to financial asset schemes, a highly competitive sub-industry characterised predominantly by large institutions each operating multiple schemes, the KPMG report does not claim to be representative of the entire managed funds industry. Furthermore, it is difficult to discern the extent to which these cost savings to scheme investors can be attributable to changes brought on by the *MIA*, given that most of industry migrated to the *MIA* regime towards the end of the transition period.

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[68] Ibid [3.6].

[69] Financial asset schemes include cash management trusts, equity trusts (domestic and international) and fixed interest trusts (domestic and international).

[70] KPMG, *Retail Registered Schemes: Fees and Charges* (2001) 12.

Furthermore, general competition in the industry is placing downward pressure on fees. As one interviewee noted:

> *The other side of the picture, which of course doesn't get picked up from a legal perspective, is the competition in the industry — the pressure on fees. This isn't the growth industry it was in the '80s, where it was a classic MBA study of a few participants, huge margins, high fees. Now you've got 100 fund managers all touting their wares. You have 50+ master trust operators offering a range of all those 100 managers, and fees are becoming more and more of an issue, so you've seen pricing come down. The managers have probably given up those 3.5 basis points [a reference to the interviewee's opinion on the net gain to the manager from internalising the former trustee fee] resulting from the elsewhere because of the general pressure on the industry.*
>
> Senior manager of an independent trustee company.

The costs of transition and the ongoing costs of compliance for smaller operators involved in comparatively less mainstream fund management activities (such as primary production schemes and mortgages schemes) are not known with certainty. However, the following comments were offered:

> *I'd say it has increased the cost of running a business like ours by 10% or 15%.*
>
> Managing Director of a RE with funds under management of approximately $85 million, operating three social infrastructure schemes.

> *I believe it was about $50,000 per vehicle. So if you had two it was $100,000 and if you had 20 it was $1 million (although you probably get some economies of scale coming through). It was certainly not a cheap exercise so there was one-off hits there which you may or may not choose to pass on [to investors] … Some of those things are commercial decisions because you have a cap on your MER.*
>
> Senior manager of an independent trustee company.

> *Hard to assess as the business has more than doubled in size and there is some scalability. Trustee fees were high but didn't achieve nearly as much control or monitoring.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating 21 financial asset schemes.

> *Issues such as incorporating a public company, legal support etc have meant that the costs to this firm have been of the order of $100,000 over the past two years.*
>
> Managing Director of a RE having funds under management of less than $50 million, operating one mortgage investment scheme.

Other industry bodies such as the Australian Direct Property Investment Association ('ADPIA') and the Mortgage Industry Association of Australasia ('MIAA'), which respectively represent property investment schemes and mortgage investment schemes, have not to date published any research comparable to the IFSA/KPMG report.

Specific and ongoing costs

In our survey of REs, we asked them to estimate the total annual remuneration paid to all external compliance committee members. In most cases, the number of compliance committee members was three, being two externals and one internal. Our estimations of cost are therefore based on the two external members.

The two most common remuneration brackets identified were \$25,000–\$50,000 and \$50,000–\$75,000. There was some evidence of a lower tier of remuneration in the vicinity of \$5,000–\$10,000, though this mainly seemed confined to smaller operators. There was some positive correlation between compliance committee remuneration and the number of schemes operated by the RE.

Compliance plan audits

From our survey of compliance plan auditors, it would seem that the cost of auditing a RE's compliance with the compliance plan and assessing the adequacy of the compliance plan typically ranges in the vicinity of less than \$5000 to \$5000–\$9999 per compliance plan. Others found it difficult to estimate costs and stated that the range of fees 'depends on the size, nature, complexity and number of schemes per responsible entity'.

Part 2: The Australian regulatory regime in the context of international principles

2.0 Principles for the regulation of collective investment schemes

The International Organisation of Securities Commissions ('IOSCO') established in October 1994 a core set of principles governing the regulation of collective or managed investment schemes.[71] As a general rule, these principles focus on outcomes rather than the appropriate structure or regulation for achieving those outcomes. The principles are known as the Principles for the Regulation of Collective Investment Schemes. There are 10 Principles, namely:

(1) Legal Form and Structure
(2) Custodian, Depositary or Trustee
(3) Eligibility to Act as an Operator
(4) Delegation
(5) Supervision
(6) Conflicts of Interest
(7) Asset Valuation & Pricing
(8) Investment and Borrowing Limitations
(9) Investor Rights
(10) Marketing and Disclosure

These core Principles have been supplemented by further IOSCO principles and statements, in particular:

- *Principles for the Supervision of Operators of Collective Investment Schemes*;[72]
- *Regulatory Approaches to the Valuation and Pricing of Collective Investment Schemes*;[73]
- *Conflicts of Interests of CIS Operators*;[74] and
- *Delegation of Functions*.[75]

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[71] IOSCO, *Report on Investment Management* (1994).
[72] IOSCO, *Principles for the Supervision of Operators of Collective Investment Schemes* (1997) ('*Supervision Principles*').
[73] IOSCO, *Regulatory Approaches to the Valuation and Pricing of Collective Investment Schemes* (1999).
[74] IOSCO, *Conflicts of Interests of CIS Operators* (2000).
[75] IOSCO, *Delegation of Functions* (2000).

2.1 The Australian application of the IOSCO Principles

In recognition that the Australia managed investments industry operates in a global environment, it is important that Australia's regulatory regime and governance approach be judged according to international standards. To this end, the following part of the research report assesses each of the IOSCO Principles in the context of the *Corporations Act 2001* (Cth),[76] particularly:

- Chapter 5C, which contains the substantive laws governing the operation of managed investment schemes and scheme operators; and
- Part 7.6, which sets out the licensing requirements for providers of financial services.

The aim of the analysis is to examine the underlying rationale of the Principles and the degree to which the Australian regime conforms with international principles of governance. Where the Australian regime departs from the IOSCO Principles, we seek to examine the legitimacy of this departure. As noted above, the IOSCO Principles adopt an 'outcomes-based' approach rather than prescribing the means by which those outcomes are to be achieved. Our assessment is similarly based on an 'outcomes-based' approach.

2.2 Legal form and structure

IOSCO Principle 1 states that the legal form and structure of the scheme should be so as to 'provide certainty to investors assessing their interest in a CIS [collective investment scheme] and enable a pool of investors' funds to be distinguished from the assets of other entities', without prescribing any preferred legal form. The 'certainty' requirement is intended to operate at two levels:

- certainty as to the *nature* and *value* of a scheme member's interest in a particular scheme; and
- certainty that the assets of two or more separate schemes, or the assets of the scheme and the scheme operator, are not intermingled.

The *Corporations Act 2001* (Cth) does not prescribe any particular legal form or vehicle for a managed investment scheme. This approach was adopted in the interests of allowing diversity in the industry. Nevertheless, certain factors will indirectly determine the legal structure of a scheme. First, the definition of managed investment scheme. Section 9 defines a managed investment scheme as:

> (a) a scheme that has the following features:
>
> (i) people contribute money or money's worth as consideration to acquire rights (interests) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);
>
> (ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);

[76] All section references are to the *Corporations Act 2001*, unless stated otherwise.

(iii) the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions); or

(b) a time-sharing scheme.[77]

However, a scheme structured as a body corporate is expressly excluded from the definition. This is in marked contrast to the position in the United States (and many other jurisdictions)[78] where mutual funds are commonly structured as bodies corporate.

Secondly, the RE holds scheme property on trust for members.[79] Presumably, the purpose of this provision is to make clear that, in the event of the RE's insolvency, the assets of the scheme are not available to satisfy the claims of creditors of the RE (which were incurred when the RE was acting in its personal capacity). To deem that scheme property is held by the RE on trust for members is an effective means of minimising 'institution risk', by protecting scheme assets in the event of the operator's insolvency. To this extent, it does 'enable a pool of investors' funds to be distinguished from the assets of other entities', consistent with the IOSCO Principle.

As most schemes in Australia are structured as trusts, the effect of s 601FC(2) is relatively uncontentious as, for those schemes, it merely restates what in fact is already the case. However, the section does appear to have caused some unintended consequences, which may be viewed as undermining certainty, since it creates a trust relationship between the RE and scheme members in circumstances where the parties never contemplated or intended that to be the case. Australian law firm Freehills make the point that many real property schemes are organised as syndicates where each member is a tenant in common in respect of scheme property, with the RE being appointed under the syndicate agreement to hold scheme property for each member as nominee (not as trustee of the scheme property).[80] The rights and obligations the parties have with respect to each other are intended to be contractual, and not fiduciary. However, s 601FC(2) imposes fiduciary responsibilities by deeming that scheme assets are held on trust for scheme members.

Furthermore, a registered scheme must have a constitution that is legally enforceable as between members and the RE.[81] The constitution, and the legally enforceable rights and obligations contained within it, are an additional means of providing investors with certainty as to the nature and scope of their interests in the managed investment scheme. The scheme's constitution must make adequate provision for the consideration to be paid to acquire an interest in the scheme, the scope of powers of the RE to make investments or otherwise deal with scheme property, the method by

[77] *Corporations Act 2001* (Cth) s 9. The definition then provides a list of exclusions.

[78] The following countries also permit collective schemes to be structured as bodies corporate: Canada, France (open-ended companies called 'SICAV'), Germany (joint stock investment companies which are closed-end investment schemes), Italy, Japan (security investment companies) and the United Kingdom (open-ended investment companies called 'OEIC'): IOSCO, *Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators* (2000).

[79] *Corporations Act 2001* (Cth) s 601FC(2).

[80] Freehills, *Review of Managed Investments Legislation* (2001) 8 (a submission to the *Turnbull Review*).

[81] *Corporations Act 2001* (Cth) s 601GB.

which complaints made by members are to be dealt with, and the winding up of the scheme.[82] The constitution must also set out any rights of the RE to be paid fees or to be indemnified for expenses, powers to borrow or raise money for the purposes of the scheme, and the rights of members to withdraw from the scheme (ie liquidate their investment).[83] If the scheme is structured as a trust, a written declaration of trust is invariably found in the scheme's constitution.

2.3 Custodian, depositary or trustee

IOSCO Principle 2 provides that scheme assets must be kept separate from the assets of the operator, its related entities and other schemes. The Principle requires that a custodian be appointed to hold scheme assets and that the custodian be 'functionally independent of the operator and must always act in the best interests of investors'.

Under Australian law, there is no requirement to appoint either an independent trustee or an independent custodian or depositary.[84] Even where a third-party custodian is appointed, that entity is not under a statutory obligation to act in the best interests of scheme investors. As a general rule, a third-party custodian owes no duty at all to scheme investors; the scope of its responsibilities are determined on the basis of the service agreement between the RE and itself. To this extent, Australia law neither meets the IOSCO Principle nor is it in line with collective investment scheme law and practice in the majority of OECD countries.[85]

The *Corporations Act 2001* (Cth) purports to partially satisfy IOSCO Principle 2 through the imposition of statutory duties coupled with a requirement that procedures be set out to facilitate the performance of those duties. The RE (the scheme operator) is under a statutory duty to ensure that scheme property is clearly identified as scheme property and that it is held separately from the property of the RE and of any other scheme.[86] The scheme's compliance plan — a form of self-governing and self-assessment mandate (discussed later) — must set out 'adequate measures' to ensure that this duty is discharged.[87]

Nevertheless, in practice it is common to find that registry systems — the systems and procedures adopted to discharge the duty under s 601FC(1)(i) — are outsourced to an external custodian, with formal custody arrangements and service level agreements in place between the RE and the custodian.[88] Whether or not the custodial function is outsourced, the compliance plan must make adequate provision for ensuring that scheme property is quarantined.[89] Even where a RE chooses to engage independent

[82] *Corporations Act 2001* (Cth) s 601GA(1).
[83] *Corporations Act 2001* (Cth) ss 601GA(2), (3), (4).
[84] The term 'depositary' is a term interchangeable with custodian, and is used most commonly in European jurisdictions.
[85] John Thompson and Sang-Mok Choi, *Governance Systems for Collective Investment Schemes in OECD Countries*, OECD Financial Affairs Division, Occasional Paper No 1 (2001).
[86] *Corporations Act 2001* (Cth) s 601FC(1)(i).
[87] *Corporations Act 2001* (Cth) s 601HA(1)(a).
[88] See above Part 1.7.1. Under s 601FB(2), the RE remains liable to scheme members for any loss caused by the acts or omissions of the custodian.
[89] Of course, these different scenarios will generate different compliance and monitoring requirements as set out in the compliance plan.

custodians to hold scheme property, the role being performed by the custodian is a limited one:

> *… The custodians that are there under this Act and under most of the contracts do not play the role of trustee. They can't be sued by investors either and their job is not to check the legitimacy of proofs of any investment …*
> *The moment you ask them to in the contract they run away and say that they are not interested in doing business. You're talking about people like J P Morgan Chase and State Street [both US companies]; they are not interested in being trustees in foreign countries. They'll be a bare custodian but they will not take on the fiduciary responsibility …*
> *That's all they do; they follow instructions — you look at any of the contracts that are signed. Now the reason that fund managers are using independent custodians rather than being self-trustees is two-fold. One is many of them are large REs that recognise the risks involved in self-custody and, to their credit, they are saying that we should not be trusting our own executives. Secondly, it's a complicated business. What was dismantled in trustee companies such as mine was millions of dollars that were invested in systems to enable you to electronically manage multi-million dollar share portfolios as a custodian and trustee. Now there are very few companies in the world who can put that together, having been dismantled. Now, amongst Australian companies, the whole Australian industry is hostage to three or four global custodians who can afford to make that investment … even the Commonwealth Bank and National Australia Bank would hesitate to be a self-custodian. Most fund managers couldn't afford the ongoing technological expense so they outsource as a matter of economic necessity to a diminished pool of competitors.*
>
> Managing Director of a trustee company.

Under the pre-*MIA* regime, the independent trustee was responsible for protecting the rights and interests of the investor, and was under an obligation to exercise due diligence and vigilance in carrying out its functions and duties.[90] This necessarily entailed that scheme assets be held by the independent trustee, who actively scrutinised the investment activities of the manager.[91] Trustees charged fees for these custodial and related services, which varied generally from 5–10 basis points depending on the complexity of the trusts, among other things. The *MIA* not only dismantled the role of the trustee as an overseer, but also abandoned the almost universally recognised requirement to have an independent custodian or depositary hold scheme assets.[92]

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[90] Former s 1069(1)(e)(i) of the *Corporations Law*. The obligation took the form of a covenant in the trust deed.

[91] The success (or otherwise) of independent trustees to protect the assets of scheme investors is a controversial topic. The Australian Investors Association ('AIA') have expressed the view that 'it is a historical fact that many Trustee Companies proved almost useless at protecting the assets of investors from incompetent and dishonest managers of pooled investment funds': AIA, *New Managed Investment Act Fails Investors*, Media Release, 22 March 2000. However, the Trustee Corporations of Australia would be prepared to cite a number of examples where the trustee's 'watchdog' role prevented unauthorised investments being made by the manager.

[92] These were replaced with other governance requirements such as independent boards, compliance committees and compliance plans, which are discussed throughout this report.

The elimination of the mandatory requirement for an independent trustee has also shifted the ultimate bearers of risk of failure from the priv ate sector to the public sector. As one interviewee observed:

> *Where is a fidelity fund in this industry now? ... [I]t's Parliament House in Canberra. When HIH went down, State Governments and the Federal Government paid a billion dollars of taxpayers' money because of the failure of their regulator. When a managed funds goes down, they'll pay another billion or $10 billion for the failure of ASIC to properly regulate this industry. There will be no-one else who can be sued. Unless there's any substantial capital in REs, the rest will turn around to the public purse. So we have effectively replaced a regime of private capital supporting the prudential security of retirement and non-retirement savings. We have a system which will inevitably lead to government handouts for maladministration, because there is no other substantive capitalised party who is required to stand behind the good governance of this industry. It is as simple as that.*
>
> Managing Director of an independent trustee company.

The Act permits the following persons to hold scheme property:

- the RE itself;
- an entity that is legally or commercially related to the RE; or
- an independent third-party custodian.[93]

However, ASIC may impose a licence condition on the RE that the property of the scheme be held by a third party. Such a licence condition might be imposed where the RE cannot meet certain minimum standards (both financial and non-financial) applicable to custodians.[94] It is to be noted that the circumstances under which ASIC will insist on the use of a third-party custodian depend on criteria relating to organisational capability and competence to perform the role, rather than any fundamental objection to the inherent conflict of interest where a RE (or a related party) acts as custodian. The absence of a legal requirement in the *MIA* to have an external, independent custodian to hold scheme assets may represent a significant risk, which is not sufficiently counter-balanced by other governance attributes of the regulatory regime.

At a fundamental level, the requirement to have an independent custodian reduces the potential for fraud or misappropriation of assets. This is because the assets (such as title deeds, certificates of title, share certificates) are actually held by a party that does not have an inherent conflict of interest with scheme members. Even in cases where the custodian is nothing more than a bare custodian[95] it provides a layer of accountability that is not otherwise present.

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[93] *Corporations Act 2001* (Cth) s 601FB(2).

[94] ASIC, *Managed Investments: Scheme Property Arrangements*, Policy Statement 133 (1999) [2]. Where the RE has net tangible assets (NTA) of less than $5 million, ASIC requires the RE to appoint a third party custodian. Generally, that third party custodian must have NTA of at least $5 million. See ASIC, *Managed Investments: Financial requirements*, Policy Statement 131 (2000). The minimum non-financial standards relate to organisational structure, staffing capabilities, ability and resources to perform core administrative activities, arrangements on how various assets are held and custody-related financial resources. These minimum standards are consistent with IOSCO Principle 2.2.

[95] A 'bare custodian' is an entity that holds scheme assets and acts solely on instructions from the RE — in contrast to the role previously performed by independent trustees, who scrutinised contemplated transactions to ascertain whether they were proper.

The IOSCO Principle states that the custodian 'must always act in the best interests of investors'. Australian law, both statute and general law, does not expressly recognise this principle. Chapter 5C of the *Corporations Act 2001* (Cth) is silent in relation to the duties of the custodian or other agents, though it clearly contemplates in s 601FB(2) that their activities form an important part of the managed investments industry. This is not surprising given that the policy underlying the Act is based on a 'single responsible entity' framework. The principal reason underlying the move from the two-party structure to the single responsible entity structure was to overcome the uncertainty as to which party — the trustee or the management company — was ultimately liable to scheme investors for maladministration in the operation of the scheme.[96] However, history would tend to suggest, according to one respondent, that the only money ever recovered from mismanaged schemes came from substantially capitalised and insured trustees:

> *Back when we had trustee companies, imperfect though they might have been, there were hundreds and hundreds of millions of dollars of shareholders' funds and insurance backing the responsibilities of the trustees and it resulted in hundreds of millions of dollars being paid to investors in the mid-1990s, that would not be paid today if similar misfeasance occurs. My own company paid $35 million (more than three years of our total profits) on one failed loan. Permanent Trustees paid something like $100 million in the Austwide case, and the Burns Philp insurers ended up paying $150 million in the Estate Mortgage case. Now, that type of money will not be available to compensate those investors ...*
>
> Managing Director of an independent trustee company.[97]

As this tension is purportedly resolved by making the licensed RE accountable to scheme investors in all circumstances,[98] it seemed to be unnecessary to regulate custodians, eg by imposing a duty to act in the best interests of investors. But this lack of regulation causes problems of itself; the use of custodians may give rise to complicated, and potentially irreconcilable, fiduciary obligations.

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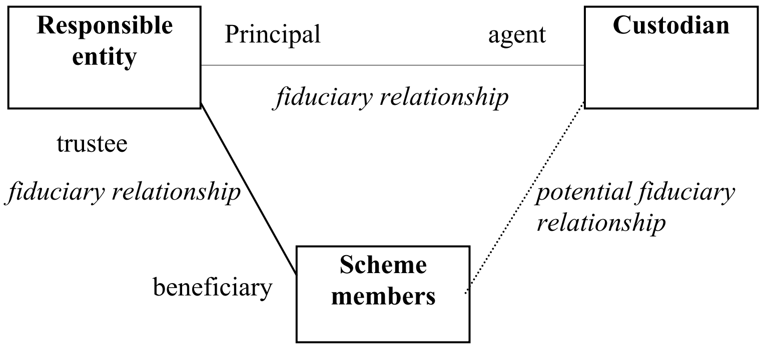
[96] The justification for not requiring a compulsory third party for holding assets and to supervise the manager is discussed in Australian Law Reform Commission, *Collective Investments — Other People's Money*, Report No 65 (1993) ch 12.

[97] The two quoted examples, Australia-Wide Management Ltd Trust and the Estate Mortgage collapses, have been quoted as being attributable to the failings of trustee companies to observe their fiduciary and legal responsibilities, and one of the principal drivers behind the 'single responsible entity' approach: see Association of Independent Retirees Inc, *Review of Managed Investment Legislation* (2001) (a submission to the *Turnbull Review*).

[98] *Corporations Act 2001* (Cth) s 601MA. It is not clear whether compliance committee members, who are subject to statutory duties under s 601JD(1), are also accountable to scheme investors. That they are subject to statutory duties, breach of which can carry civil consequences, would suggest that they might be liable, though this runs counter to the notion of having a 'single responsible entity'.

Figure 10: Fiduciary relationships



The RE owes fiduciary duties to scheme members by virtue of the requirement that the RE must hold scheme property on trust for scheme members;[99] the relationship of trustee and beneficiary being one of the well-recognised relationships giving rise to fiduciary obligations. The relationship between the RE and the custodian is one of principal and agent; agency being another one of the traditional and well-accepted relationships that imposes fiduciary duties on the agent.

There is also the *potential* for a fiduciary relationship to exist between the custodian and scheme members. Despite the underlying intention of ss 601FB(2) and 601MA, the legislation does not expressly exclude custodians from liability.[100] Although the appointment of a third-party custodian does *not* mean that scheme assets are held in trust by the custodian for the benefit of scheme members, it does not change the nature of the trust (or more particularly, a trust embedded in a commercial contract)[101] between the RE and scheme members. It also does not necessarily mean that a custodian cannot be in a direct fiduciary relationship with beneficiaries of the trust (scheme investors).[102] If the requisite indicia of a fiduciary relationship[103] can be derived from the role performed and services provided by the custodian (or indeed any agent engaged by the RE), a finding of fiduciary responsibility may well be warranted. While it is an open question whether the general law may be moving towards the imposition of a fiduciary duty owed by custodians to scheme investors, it should be noted that the High Court has said that the categories of fiduciary relationship are not closed, and that where it does exist, the scope of the fiduciary duty must be determined according to the nature of the relationship.[104]

The type of custodians contemplated by the *Corporations Act 2001* (Cth), that being bare custodians, unlicensed and otherwise unregulated, are not necessarily immune

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[99] *Corporations Act 2001* (Cth) s 601FC(2) These fiduciary duties co-exist with the statutory duties under s 601FC.
[100] In fact, s 601MA(3) seems to leave open the possibility that custodians could be held liable at general law.
[101] Pamela Hanrahan, 'The Responsible Entity as Trustee' in Ian Ramsay (ed), *Key Developments in Corporate Law and Trusts Law: Essays in Honour of Professor Harold Ford* (2002), para [10.4].
[102] *Australian Securities Commission v AS Nominees Ltd* (1995) 18 ACSR 459, 472–3 (Finn J).
[103] For the indicia of a fiduciary relationship, see *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41.
[104] Ibid 96 (Mason J).

from liability to scheme investors. While this issue does not directly compromise the protection of investors, it does not promote certainty in the industry.

2.4 Eligibility to act as an operator

IOSCO Principle 3 states that the regulatory regime should impose standards of conduct and minimum eligibility standards on operators of collective investment schemes. This IOSCO Principle has been further supplemented by *Principles for the Supervision of Operators of Collective Investment Schemes*.[105] These are referred to as the IOSCO Supervision Principles.

In Australia, the implementation of these IOSCO Principles is achieved through both the *Corporations Act 2001* (Cth) directly and through the licensing regime administered by ASIC.

2.4.1 Honesty and fairness

IOSCO Principle 3.1 states that an operator should observe 'high standards of integrity and fair dealing while acting in the best interest of a CIS'. This is reflected in the *Corporations Act 2001* (Cth) in the form of statutory duties, most notably the duties to:

> (a) act honestly; and
> …
> (c) act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests; and
> (d) treat the members who hold interests of the same class equally and members who hold interests of different classes fairly; and
> (e) not make use of information acquired through being the responsible entity in order to:
>   (i) gain an improper advantage for itself or another person; or
>   (ii) cause detriment to the members of the scheme …[106]

This duty is owed to scheme members.

Identical statutory duties are imposed on officers (directors and senior executives) of the RE and, to a lesser extent, employees of the RE.[107] These duties are also owed to scheme members. Officers and employees also owe duties to the RE under part 2D.1 of the *Corporations Act 2001* (Cth). Where there is a conflict between a duty owed to the RE under part 2D.1 and a duty owed to the scheme members under part 5C.2, the latter duty overrides the former.[108]

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[105] IOSCO, *Supervision Principles*, above n 72.
[106] *Corporations Act 2001* (Cth) s 601FC(1).
[107] *Corporations Act 2001* (Cth) s 601FD(1) (duties of officers of the RE). Under s 601FE(1), employees of the RE are under a statutory duty not to misuse information or their position in order to gain an improper advantage or to cause detriment to members of the scheme.
[108] *Corporations Act 2001* (Cth) ss 601FD(2), 601FE(2). In addition, where there is a conflict between members' interests and those of the RE, an officer of the RE must give priority to the members' interests: s 610FD(2)(c).

In addition, each responsible officer[109] of the RE must provide a written declaration about any matters in the last 10 years that reflect on their character and honesty, as part of the RE's licence application.[110] Australian Federal Police Character Checks must also be provided.[111]

Supervision

Under the IOSCO Supervision Principles,[112] supervision should seek to ensure that a scheme operator meets high standards of competence, integrity and fair dealing, in particular:

- Its business is conducted according to 'timely and best execution'[113] and 'fair allocation' procedures;[114]
- The risk of 'churning'[115] is eliminated or at least minimised;
- Services that are subject to 'soft dollar arrangements'[116] are for the benefit of the CIS; and
- An operator does not offer or accept any inducement that is likely to significantly conflict with the duties owed by the operator to scheme members.[117]

Australian law purports to internalise compliance and compliance-monitoring by entrusting the day-to-day supervision of a RE to the RE itself, under which the principles of best execution and fair allocation of trades, the avoidance of churning and inducements and the management of soft dollar arrangements — and the monitoring and supervision of all of these — are primarily dealt with in the scheme's compliance plan. The responsibility for day-to-day, pro-active supervision of the RE's compliance with the plan lies exclusively with the internal officers of the RE. The

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[109] Officers or agents of the RE who will be performing duties in connection with holding the relevant dealers licence, including those persons who are responsible for making decisions about the ongoing operations of the scheme: ASIC, *Responsible Entities and Investor Directed Portfolio Service Operators: Licensing Kit* (2001) 6.

[110] These include disciplinary actions, convictions, charges pending, suspension or membership refusal by professional bodies, fraud and theft, among others: ASIC, *Application for a Licence as a Dealer*, above n 15, Q8.

[111] Ibid Q9.

[112] The 'Conduct of Business' Supervision Principles: IOSCO, *Supervision Principles*, above n 72, Principles 1.1–1.6.

[113] Timely and best execution means 'the transaction was executed as soon as was reasonably practicable and was executed on terms that were the best available, taking into account the market, the kind and size of the transaction concerned and the characteristics of the executing broker': IOSCO, *Supervision Principles*, above n 72, Principle 1.1.

[114] Fair allocation means, eg, where a CIS operator has placed an order for more than one client, including the CIS, that the intended basis of allocation of the intended transaction was adhered to. Without fair allocation procedures, there is a risk that the allocation of a transaction may be delayed until subsequent price movements are known, thereby allowing an allocation which favours one client over the CIS.

[115] Churning is the industry term for trading in the scheme's assets, which is excessive in light of the scheme's stated investment objectives. Churning generates brokerage, to the detriment of the scheme.

[116] Soft dollar arrangements are a form of inducement, whereby operators have agreements with counterparties under which the counterparties agree to pay for services (such as computer facilities and research material) for the operator in return for broking business which will generate an understood or agreed level of commission: IOSCO, *Supervision Principles*, above n 72, Principle 1.5.

[117] It is noted that most of these examples of conflicts of interest are 'financial asset scheme'-centric.

compliance plan itself must make adequate provisions for the monitoring and supervision of the procedures set out in the compliance plan.

Australian law also provides for external, independent supervision, taking the form of initial 'supervision' by ASIC at the licensing/registration stage and 'after the event' supervision by a compliance committee (or equivalent) and a compliance plan auditor. While ASIC does not 'approve' compliance plans, it has indicated that it will actively assess them to determine their adequacy in deciding whether or not to register the scheme under s 601EB(1).[118]

The RE's compliance with the compliance plan must also be 'monitored' by either the scheme's compliance committee or, where such a committee does not exist, by the independent members of the board of the RE.[119]

In addition, an auditor of the compliance plan is required to carry out an annual audit of the RE's compliance with the compliance plan and to give an opinion as to whether the plan continues to meet the requirements of the *Corporations Act 2001* (Cth). According to a sample of auditors surveyed, this entails the following:

> *Determine RE's processes, systems and reporting*
> *Understand RE's monitoring — extent, type and impact*
> *Assess risk*
> *Interview those performing monitoring the monitoring*
> *Test check key procedures*
> *Attend compliance committee meetings.*
>
> *This firm has a client specific program aimed at dealing with all issues required to be undertaken and as set out in the compliance plan. This is drafted for each client using a base template drawn from AGS 1052: 'Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes'.*

There are inherent limitations of auditing compliance with a compliance plan.[120] This is the principal reason why audit opinions are expressed in terms of reasonable assurance rather than guarantees.

It is to be noted that the *MIA* imposes 'revisionist' supervision mechanisms on organs external to and independent of the RE — 'after the event' checks, which are in turn based on internal reporting. The roles contemplated by the compliance committee and the compliance plan audit are not roles of intervention. If there is any 'interventionist' approach within the *MIA*, it lies within the compliance plan itself and those compliance managers whose day-to-day jobs revolve around it.

From an 'interventionist' perspective, the person or entity responsible for ensuring that the 'scheme operator meets high standards of competence, integrity and fair dealing' is the RE itself. In some respects, such an approach reflects the legitimate aim of internalising compliance functions and responsibilities. However, from a governance perspective, the effectiveness of having 'interventionist' mechanisms

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[118] ASIC, *Compliance Plans*, above n 47. See the series of *Commentary on Compliance Plans Received by ASIC*, released in March 2000: see above n 36.
[119] Practical examples of how this role is being performed are set out in above Part 1.6.1.
[120] Auditing and Assurance Standards Board, above n 53, [24], [25].

internal to the organisation but only 'revisionist' external supervisory mechanisms, particularly in circumstances where the RE is in a position of inherent conflict of interest, is highly questionable. While such an approach is consistent with the 'single responsible entity' framework, it is problematical. Superimposing 'after the event' checks and reviews by compliance committees (or independent board members) or compliance plan auditors may be of limited practical benefit in the event of fraud or misappropriation.[121]

It is true that ASIC's initial licensing criteria applicable to REs (a form of preliminary supervision) is far more rigorous that that which applied under the pre-*MIA* regime, and it is likely that such a rigorous process deters potential scheme operators who do not meet high standards of integrity and competence. However, ASIC's licensing regime is an isolated, point-in-time form of supervision, and there is no provision in the Act for the ongoing review of licences and licence conditions. ASIC does, however, have the power to conduct surveillance checks under s 601FF, and has used this power in the past,[122] though it is suggested that the limited resources of a government regulator will prevent any thorough review of the industry, a conclusion which ASIC itself has conceded.

2.4.2 Capability

IOSCO Principle 3.2 states that an operator should have sufficient human and technical resources to carry out the necessary functions of funds management. This is reflected in the licensing requirements imposed by ASIC.

To operate a managed investment scheme, the RE must be a public company and must hold an Australian financial services licence.[123] As part of that licence application, the RE must demonstrate that it has the 'capacity to deal with the current and future operational demands of the scheme'. This must include details of schemes currently managed; a diagram of the organisational structure of the entity, including staff numbers, functions and responsibilities and reporting lines; information about access to product, market and legal research; details of accounting, computing and operating systems; anticipated growth in funds over the next five years and the types of distribution channels the entity intends to use to sell interests in the scheme.[124]

2.4.3 Capital adequacy

IOSCO Principle 3.3 states that an operator must maintain adequate financial resources to meet investment business commitments and to withstand business risks.

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[121] The practical operation of compliance committees (and to a lesser extent, compliance plan auditors) have been discussed in earlier in this report.

[122] ASIC, *Results from the 1999 Managed Investment National Surveillance Review*, Media Release 00/156 (2000); ASIC, *2000–2001 Surveillance Outcomes for Responsible Entities*, above n 52; ASIC, *ASIC Launches Major Investigation into Solicitors Mortgage Schemes*, Media Release 01/055 (2001); ASIC, *Solicitors' Mortgage Scheme Investigation Update*, Media Release 01/277 (2001).

[123] *Corporations Act 2001* (Cth) s 601FA.

[124] ASIC, *Application for a Licence as a Dealer*, above n 15, A4.

This is reflected in ASIC's licensing conditions relating to mandatory net tangible assets ('NTA') for REs and custodians.[125] While the NTA requirements are not designed to serve as a form of fidelity fund to compensate investors in the event of loss due to fraud, misappropriation or negligence, their underlying purpose is to protect investors. The underlying rationale of the NTA requirements, according to ASIC, is to ensure that the entity is of some substance and that it has sufficient financial resources to enable assets to be transferred if the entity is removed.[126]

The RE must have and maintain a minimum of $50,000 NTA, regardless of the value of scheme assets and regardless of whether it uses a third-party custodian. However, if the value of all scheme property is greater than $10 million, the NTA must be an amount equal to 0.5% of the value of those scheme assets as disclosed in the latest financial statements of the scheme, up to a maximum of $5 million.[127]

The basic scale of the legislative NTA rules is indicated in the table below.

Table 19: NTA scales

Value of scheme property	**Minimum NTA requirement**
$1 million	$50,000
$5 million	$50,000
$10 million	$50,000
$50 million	$250,000
$100 million	$500,000
$500 million	$2.5 million
$1000 million	$5 million
$2500 million	$5 million
$5000 million	$5 million

The capital adequacy rules under the legislation are imposed on the RE, irrespective of whether the entity holds scheme property. While this approach is consistent with the 'single responsible entity' framework, it would have seemed more logical to impose the capital adequacy rules on both the RE and any other entity who has custody of the scheme assets. Where scheme property is held by a third-party custodian (who is not subject to direct regulation), and that custodian is removed, a capitalised RE with NTA of $5 million will be of little practical benefit to protecting investors' interests if the custodian does not have sufficient financial resources to enable assets to be transferred.

Fortunately, ASIC's licensing policy remedies the legislative lacuna. Where the RE has less than $5 million in NTA, ASIC will require as part of the licence condition that a third-party custodian be used to hold scheme assets, with that custodian being indirectly subject to capital adequacy requirements through the licensing conditions

[125] ASIC, *Financial requirements*, above n 94, [12]–[21].
[126] Ibid [20].
[127] *Corporations Act 2001* (Cth) s 784(2A). The RE must have access to sufficient financial resources to meet reasonably foreseeable and ongoing scheme-related cash requirements for a minimum period of three months. However, this is more in the nature of liquidity adequacy rather than capital adequacy.

imposed on the RE.[128] This prevents the capital adequacy rules under the legislation being diluted through the delegation of custodial functions. Generally, custodians must have NTA of at least $5 million, although there are also exceptions under which third-party custodians may be permitted to hold a minimum NTA of $500,000.[129] This reflects ASIC's underlying policy that, subject to the exceptions noted below, entities that are not substantially capitalised ought not be allowed to hold scheme property, even where the RE can meet other minimal operational standards for holding scheme property.[130]

However, even where REs have NTA of less than $5 million, ASIC will not insist on the use of a third-party custodian in all circumstances. There are two principal exemptions. First, where the nature of the scheme assets are such that they cannot practically be held by a custodian (such as livestock and agricultural produce), are contractual or licence rights or are certain mortgages or title deeds held under a mortgage, or where the scheme involves making use of real property as part of a serviced apartment, hotel or resort complex etc.[131] Secondly, where the RE meets certain minimum operational standards for holding scheme property[132] and has NTA of at least $500,000 and provided all the assets of the schemes are of a certain limited type.[133]

Not unexpectedly, finding consistent views in relation to the appropriateness of the NTA rules under the *Corporations Act 2001* (Cth) proved difficult. There are tensions at both the lower and upper end of the NTA thresholds.

At the lower end of the scale, to increase the minimum NTA requirement of $50,000 would create REs of greater substance, though this would not necessarily deliver greater protection of investors' interests to any material degree. Such an approach might also have the undesirable effect of stifling competition within the managed investments industry.

> *... If the NTA backing requirements were to change, then the Government would be effectively locking out small operators in the funds management industry, and this would not be a desired outcome for small to medium sized enterprises, and perhaps the investors who would otherwise be subject to domination by large fund managers.*
>
> Representative of an industry body and legal adviser to numerous property and agricultural syndicates.

A second issue with the capital adequacy rules in their application to third-party custodians is that they fail to reflect that custodians often act for a number of REs operating a number of schemes.

> *The custodial situation causes me immense concern as the RE, if it does not maintain the required $500,000 NTA, may appoint a Custodian. The Custodian*

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128 ASIC makes no distinction between an independent custodian and a related party custodian for the purposes of capital adequacy.
129 ASIC, *Financial Requirements*, above n 94, [7].
130 ASIC, *Scheme Property Arrangements*, above n 94.
131 ASIC, *Financial requirements*, above n 94, [5A].
132 ASIC, *Scheme Property Arrangements*, above n 94 and see above n 125 and accompanying text.
133 ASIC, *Financial requirements*, above n 94, [6].

> *may have an NTA of greater than $500,000 (ie, for example $653,000 — which includes WIP as this is an accounting practice). This Custodian may be custodian to numerous projects, using the same minimal NTA. The Custodian is required to hold funds in the applications and proceeds accounts and these can be substantial ... I am aware of one Custodian with an NTA of $632,728 who acts as custodian to 28 schemes. Although some are quite small, at the time of the capital raising they may be holding over $50 million of investors funds, with minimal NTA.*
>
> Professional compliance committee member.

At the upper end of the scale, one can appreciate the view that a RE (or a custodian), with funds under management in excess of $10 billion, but with NTA of $5 million (or less), might represent an unacceptable risk to investors, particularly if there are shortcomings in the governance and supervisory structures. In some respects, this view may reflect a misunderstanding of the capital adequacy requirements.

However, to have funds under management growing at an unprecedented rate, and at the same time to have capital adequacy rules subject to ceilings, might over time undermine investor confidence. To link the amount of the NTA requirement to funds under management (with no NTA ceiling) is one option. This would align growth in funds under management with capital adequacy levels. However such an approach would disproportionately burden large operators, the costs of which would ultimately be borne by scheme investors.

If the concerns over the adequacy of the NTA rules are based upon concerns over the size of funds under management, then perhaps those concerns are misdirected and ought to be directed at levels of professional indemnity insurance. Under Australian law, the minimum cover required for professional indemnity insurance to protect against loss arising from negligence or fraud is the lesser of $5 million or the value of the scheme assets,[134] although entities may be well advised to insure for amounts greater than $5 million. However, many insurers would be unwilling to have exposures greater than $10 million on single policies and of those that are willing to provide such cover, they would be inclined to charge high insurance premiums, which may be prohibitive to many operators, even the larger ones.

In some respects to contemplate the linking of professional indemnity cover to funds under management reflects the view that the compliance and supervisory governance structures are inadequate. That Australian law mandates only a $5 million threshold seems to reflect the view that there are adequate safeguards in place in the form of appropriate licensing of REs, compliance plans, compliance plan auditors and compliance committees. However, as is argued elsewhere in this report,[135] the adequacy of these arrangements are to date relatively untested.

2.4.4 Diligence and effectiveness

IOSCO Principle 3.4 states that an operator should act with due skill, care and diligence and employ the resources and procedures to achieve this end. Australian law purports to meet this principle through a fairly rigorous licensing process and through

[134] Ibid [18].

[135] See above Part 2.4.2 and the discussion of IOSCO Principles 5 and 6 below Parts 2.6–2.7.

the imposition of statutory duties, which are respectively administered and enforced by the regulator.

The *Corporations Act 2001* (Cth) imposes a statutory duty on the RE (and officers of the RE) to exercise the degree of care and diligence that a reasonable person would exercise if they were in the RE's (or officer's) position.[136] In addition, before ASIC grants an Australian Financial Services Licence to a RE, it must be satisfied as to the adequacy of the educational qualifications and experience of each responsible officer.[137]

Furthermore, the RE must have a compliance plan for each scheme, which sets out adequate measures and procedures that the RE is to apply in operating the scheme.[138] The compliance plan must set out arrangements for, among other things, the segregation of scheme property, the proper functioning of the compliance committee (if so required), ensuring that scheme property is valued at regular intervals, ensuring that the compliance plan is audited and ensuring that adequate records of the scheme's operation are kept.[139]

2.4.5 Operator specific powers and duties

IOSCO Principle 3.5 states that an operator has a duty to act in accordance with, and must not exceed the powers conferred by, the scheme's constituting documents.

The *Corporations Act 2001* (Cth) requires a scheme's constitution to make adequate provision for the powers of the RE in relation to making investments or otherwise dealing with scheme property[140] and, where applicable, details of powers to borrow or raise money for the purposes of the scheme.[141]

These powers are coupled with statutory duties to ensure that the scheme's constitution meets the requirements of the Act[142] and carry out any other duty that is conferred on the RE by the scheme's constitution.[143] The scheme's compliance committee provides an 'after the event' check on compliance with the scheme's constitution.[144]

2.5 Delegation

IOSCO Principle 4 states that the level of protection afforded to CIS investors should be maintained at all times, even where the operational management of CIS activities is provided by external service providers.

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[136] *Corporations Act 2001* (Cth) ss 601FC(1)(b) (RE), 601FD(1)(b) (officers of the RE).
[137] For the meaning of responsible officer, see supra n 109. The educational qualifications and experience requirements are set out in ASIC, *Responsible Entities and Investor Directed Portfolio Service Operators: Licensing Kit*, above n 109, 7–11.
[138] *Corporations Act 2001* (Cth) s 601HA.
[139] See ASIC, *Compliance Plans*, above n 47.
[140] *Corporations Act 2001* (Cth) s 601GA(1)(b).
[141] *Corporations Act 2001* (Cth) s 601GA(3).
[142] *Corporations Act 2001* (Cth) s 601FC(1)(f).
[143] *Corporations Act 2001* (Cth) s 601FC(1)(m).
[144] *Corporations Act 2001* (Cth) s 601JC(1)(b)(ii).

2.5.1 Responsibility

IOSCO Principle 4.1 states that an operator should take legal responsibility for the acts or omissions of any person to whom it delegates any part of the provision of services to a CIS.

The *Corporations Act 2001* (Cth) confers power on a RE to appoint an agent to do anything that the RE is authorised to do in connection with the scheme.[145] In practice, agents or third parties are often used for many purposes, principally for administrative and accounting functions, such as holding scheme property (custodians), record-keeping, performance of income and distribution calculations and collection and distribution of income earned from investments, payment of fees of the RE and others, and the processing of applications, redemptions and distributions.[146] The use of related-party entities as external service providers is permitted by the Act and, if used, are not subject to additional regulation.

Legal accountability for the acts or omissions of an agent remain with the RE. The RE is taken to have done (or not to have done) anything that the agent has done (or failed to do) because of their engagement, even where the agent is acting fraudulently or outside the scope of their authority.[147] This 'deeming rule' applies, among other things, for the purposes of determining whether there is a liability to scheme members.

The risk of fraud by the delegate is thus borne by the RE, irrespective of its diligence in monitoring the actions of its delegate. Although the RE can make provision in the scheme's constitution for the RE to be indemnified out of scheme property for liabilities incurred in relation to the performance of its duties, those rights are only available in relation to the 'proper performance of those duties'.[148]

The 'strict liability' criterion imposed on REs in relation to the acts of its agents is, however, inconsistent with the regulation of superannuation trustees under the *Superannuation (Industry Supervision) Act 1993* (Cth) ('*SIS Act*'). Section 56 of the *SIS Act* entitles a trustee to be indemnified out of fund assets, except where the trustee has failed to act honestly, or intentionally or recklessly failed to exercise the required standard of care and diligence. At least one industry association has questioned the differing treatments of REs and superannuation trustees in relation to the right to be indemnified out of scheme/fund assets.[149]

2.5.2 Competency and ongoing monitoring of delegate

IOSCO Principles 4.2 and 4.3 provide that the operator must be able to show that a delegate is and remains competent to undertake the relevant function and that the

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145 *Corporations Act 2001* (Cth) s 601FB(2).
146 Whether and to what extent delegates are used in practice depends on the nature and size of the scheme, logistical capability and commercial considerations.
147 *Corporations Act 2001* (Cth) s 601FB(2).
148 *Corporations Act 2001* (Cth) s 601GA(2)(b).
149 IFSA, *Submission to the Review of the Managed Investments Act 1998* (2001) app 1, recommendation 2 (a submission to the *Turnbull Review*).

operator should ensure that procedures are in place to monitor the activities of the delegate.

Australian law purports to meet these Principles through the process of licensing the RE. An application for a licence by the RE must provide details of the selection process for external service providers (both custodians and any other agents) and procedures for monitoring compliance and performance.[150] For example, in relation to agents (other than custodians), the proposed RE must provide satisfactory answers to a number of questions, including:

> (c) In what way did the process you used to select your service provider enable you to know that the service provider has the capacity to carry out its delegated functions, in compliance with the Act and the scheme constitution? …
> (f) How have you satisfied yourself that the service providers' key senior staff are of good character and that they have, and will continue to have, the expertise and capacity to perform their duties satisfactorily? …
> (g) What monitoring processes will you use to ensure that the service provider continues to perform satisfactorily and continues to meet the terms of your contract with them, and continues to comply with the Act and the scheme's constitution? …[151]

In relation to scheme property custodians, the proposed RE must provide details as to:

> (a) the custodian organisational structure that supports the clear identification and the segregation of scheme property from the assets of other managed investment schemes and the custodian including safeguards in place to protect those assets …
> (c) the reporting structure of the custodial staff in relation to both business and compliance issues …
> (f) the process followed to ensure any external custodian appointed will meet and continue to meet minimum standards for holding scheme property. Include any details of the agreement in place between the responsible entity and the custodian.[152]

While ASIC has the power to either suspend or revoke a licence granted to a RE[153] in certain circumstances, the Act does not provide for any periodic review of licences and the conditions attached to them. Furthermore, there are no licensing requirements imposed on external service providers in their capacity as external service providers.[154]

The *Corporations Act 2001* (Cth) itself does not impose a direct requirement on the RE to ensure the ongoing competency of external service providers or to monitor their performance on an ongoing basis. However, the RE must set out in a compliance plan adequate measures to ensure that the scheme is operated in compliance with the Act and the scheme's constitution.[155] Given that a RE is under a statutory duty to exercise care and diligence in carrying out its responsibilities,[156] procedures for the monitoring

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[150] ASIC, *Application for a Licence as a Dealer*, above n 15, A5, A9.
[151] Ibid A5.
[152] Ibid A9.
[153] *Corporations Act 2001* (Cth) ss 915B–915C.
[154] Subject of course to the nature of the external service provider's activities. If the external service provider is carrying on a financial services business, then the entity would have to be appropriately licensed under s 911A of the *Corporations Act 2001* (Cth).
[155] *Corporations Act 2001* (Cth) s 601HA.
[156] *Corporations Act 2001* (Cth) s 601FC(1)(b).

of external service providers would be expected to be addressed in the scheme's compliance plan.[157]

The Act is premised on the view that it would be imprudent for a RE not to ensure that the delegate is performing adequately given that the RE remains legally accountable for the actions of the delegate under s 601FB(2) and so its Financial Services Licence is at risk. However, this may not reflect the commercial reality, particularly where the custodian is a related party. As discussed in above Part 1.7, the adequacy of monitoring of delegates continues to be a problem for the industry, being a direct result of a lack of regulation of external service providers.

2.5.3 Ongoing co-operation

IOSCO Principle 4.4 states that the operator should provide all reasonable means to enable a delegate to fulfil its responsibilities and should ensure that the contractual relationship between the operator and the delegate is unambiguous.

The commercial relationship between the RE and any external service provider is indirectly and mildly regulated, at least initially, through ASIC's licensing regime. Beyond this point-in-time licensing criteria, which applies exclusively to the RE, there is no other ongoing regulation; the parties are free to contract in the terms that they see fit.

2.5.4 Level playing field

IOSCO Principle 4.5 states that the use of delegates should not diminish the primary regulation of the CIS, and that the regulation of the delegate should embody similar principles to those regulating the scheme.

The 'single responsible entity' approach adopted by chapter 5C of the *Corporations Act 2001* (Cth) means that there is no direct regulation of the delegates engaged by the RE.

The lack of direct statutory regulation of delegates, and perhaps more importantly, the lack of any statutory immunity from legal liability, has created some uncertainty concerning the scope of a delegate's legal liability under general law.[158] To overcome this uncertainty, one commentator has suggested that Chapter 5C should be amended so as:

> to make it clear that the custodian is not liable to investors when acting on instructions from the [responsible entity] and is not bound to inform itself of the terms of the scheme constitution, compliance plan or offer documents, nor is the custodian required to take into account any of the contents of those documents, but is bound to act only on the basis of the responsible entity's instructions …[159]

Such an approach is consistent with the 'single responsible entity' framework. However, it would have the effect of further weakening the governance framework

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[157] ASIC, *Compliance Plans*, above n 47, annex item 11.
[158] See above n 98 and accompanying text.
[159] Minter Ellison Lawyers, *Review of the Managed Investments Act 1998 (MIA)* (2001) (a submission to the *Turnbull Review*).

for the protection of investors by concentrating the risk of fraud, unauthorised investments or negligence into the hands of the RE.

2.5.5 Compliance

IOSCO Principle 4.6 states that a delegate should comply with all regulatory requirements applicable to the conduct of its business.

As stated above, the 'single responsible entity' approach adopted by chapter 5C means that there is no direct regulation of external service providers.

2.6 Supervision

IOSCO Principle 5 states that a regulatory authority must take overall responsibility for the supervision of CISs. IOSCO Principle 5 has been further supplemented by *Principles for the Supervision of Operators of Collective Investment Schemes*.[160]

In Australia, ASIC has regulatory responsibility for the *Corporations Act 2001* (Cth), including chapter 5C.

2.6.1 Registration and authorisation

The Principles state that a CIS must be registered or authorised before the commencement of marketing of its units.

Under the *Corporations Act 2001* (Cth), a managed investment scheme must be registered with ASIC if the scheme has more than 20 members; or if it was promoted by a professional promoter.[161] As the RE is given the power to 'operate the [registered] scheme',[162] it implies that a scheme must not be operated until the RE is authorised. A RE must be a public company that holds an Australian Financial Services Licence.[163] The RE is authorised to operate the scheme through the licensing process.

2.6.2 Inspections and investigations

The IOSCO Principle states that the regulatory authority (or its delegate, such as the CIS's auditor) should have the means to investigate conduct relating to the operation of the CIS.

This is reflected in the *Corporations Act 2001* (Cth) in two areas. First, ASIC has the power to conduct surveillance checks so as to ascertain whether the RE is complying with the Act and the scheme's compliance plan and constitution.[164] Several surveillance reviews have been undertaken by ASIC since the commencement of the

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[160] IOSCO, *Supervision Principles*, above n 72.
[161] *Corporations Act 2001* (Cth) s 601ED(1). If all the issues of interests in the scheme were excluded issues, then the scheme need not be registered.
[162] *Corporations Act 2001* (Cth) s 601FA.
[163] See ASIC *Application for a Licence as a Dealer*, above n 15.
[164] *Corporations Act 2001* (Cth) s 601FF. For this purpose, ASIC may exercise its investigation powers under pt 3, div 3 of the *Australian Securities and Investments Commission Act 2001* (Cth).

MIA on 1 July 1998,[165] all of which have been targeted surveillances of selective portions of the managed investments industry. The ability of ASIC to sustain reviews of this nature in the future remains a matter of concern. ASIC has conceded that it is unlikely to able to adequately fulfil the role contemplated by scheme investors:

> Because so much of ASIC's work … is responsive and driven by scheme applications, any stress on resources impacts directly and disproportionately on our ability to supervise the industry in a pro-active way — by undertaking surveillance, providing guidance and adjusting policy settings.[166]

Secondly, the compliance plan of the registered scheme must be audited by a registered company auditor.[167] Auditors of the compliance plan can only be removed by the RE on ASIC giving its consent to the removal.[168] The auditor is required to examine the scheme's compliance plan, audit the RE's compliance with the compliance plan and provide an opinion as to whether the RE complied with the plan and as to whether the plan continues to meet the requirements of the Act.[169]

Being an annual, 'after the event' test, the effectiveness of a compliance plan audit, as an intervention measure to protect against fraud or unauthorised investments, is limited. However, its principal benefit lies in its ability to identify shortcomings in a RE's compliance plan.

2.6.3 Powers of the regulatory authority

The IOSCO Principles state that the regulatory authority must have adequate powers to protect the interests of investors.

The *Corporations Act 2001* (Cth) confers on ASIC extensive powers to protect the interests of scheme members, including the power to:

- cancel or suspend a RE's licence;[170]
- impose additional licence conditions;[171]
- make stop orders restraining the offer of interests in the scheme;[172]
- commence civil penalty proceedings against the RE, or one of its officers and employees for breach of a statutory duty;[173]
- commence criminal proceedings;

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[165] ASIC, *1999 Managed Investment National Surveillance Review*, above n 122; ASIC, *2000–2001 Surveillance Outcomes for Responsible Entities*, above n 52; ASIC, *ASIC Launches Major Investigation into Solicitors Mortgage Schemes*, above n 122; ASIC, *Solicitors' Mortgage Scheme Investigation Update*, above n 122.

[166] ASIC, *Submission*, above n 16, 48.

[167] *Corporations Act 2001* (Cth) s 601HG.

[168] *Corporations Act 2001* (Cth) s 601HH.

[169] *Corporations Act 2001* (Cth) s 601HG(3). See also ASIC, *Audit of Compliance Plans of Managed Investment Schemes*, Information Release 00/012 (2000); Auditing and Assurance Standards Board, *Compliance Plans of Managed Investments Schemes*, above n 53.

[170] *Corporations Act 2001* (Cth) s 915B(3), 915C.

[171] *Corporations Act 2001* (Cth) s 914A.

[172] *Corporations Act 2001* (Cth) s 1020E.

[173] *Corporations Act 2001* (Cth) s 1317E. The statutory duties are set out in ss 601FC, 601FD and 601FE, which are expressed to be civil penalty provisions. When a Court makes a declaration of a contravention of a civil penalty provision, ASIC may then seek a pecuniary penalty order (s 1317G) or a compensation order (s 1317H).

- accept enforceable undertakings;[174] and
- deregister a scheme.[175]

2.6.4 Third-party supervision

The IOSCO Principles state that the regulatory regime may provide for an independent third party (in addition to the regulatory authority) to supervise the activities of the operator.

The *Corporations Act 2001* (Cth) provides for third-party supervision of the RE by two means. First, through the requirement for an auditor to audit the RE's compliance with the compliance plan.[176] Secondly, through the requirement in certain (if not most) circumstances to establish a compliance committee.[177] The RE is required to establish a compliance committee if less than half of the directors on the board of the RE are 'external directors'.[178] The compliance committee must comprise at least three members, the majority of which must be 'external members'.[179]

The functions of the compliance committee are supervisory to the extent that the committee is required to:

- monitor the extent to which the RE complies with the scheme's compliance plan;
- report to the RE any breach by the RE of the Act or the scheme's constitution of which the committee suspects or becomes aware;
- report to ASIC if the committee is of the opinion that the RE will not take appropriate remedial measures in response to a report of the committee; and
- regularly assess the adequacy of the compliance plan.[180]

Where a compliance committee is not required to be established, it is expected that the majority of the board consisting of external directors would exercise sufficient independent oversight of the RE although, as pointed out above in Part 1.6.6, the independent directors are not under specific obligations to monitor and supervise the primary compliance organs.

2.7 Conflicts of interest

IOSCO Principle 6 recognises that an operator of a CIS may have interests that conflict with the interests of investors in the CIS. This conflict of interest arises due to the separation of 'ownership' of the funds from its management.

The IOSCO Paper, *Conflicts of Interests of CIS Operators*,[181] contains a relatively detailed analysis of conflict of interest scenarios in the operation of a CIS. The Paper notes that conflicts of interests can occur in the following situations:

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[174] *Australian Securities and Investments Commission Act 2001* (Cth) s 93A.
[175] *Corporations Act 2001* (Cth) s 601PB.
[176] See above Part 2.6.2.
[177] *Corporations Act 2001* (Cth) s 601JA(1).
[178] 'External director' is defined in s 601JA(2) of the *Corporations Act 2001* (Cth).
[179] *Corporations Act 2001* (Cth) s 601JB. The definition of 'external member' in s 601JB(2) is identical to the definition of 'external director' in s 601JA(2).
[180] *Corporations Act 2001* (Cth) s 601JC.

- *Principal transactions involving the CIS and an affiliated party*
  This is a situation where the CIS enters into the transaction *with* an affiliated party[182] as a principal. The 'affiliated party' could be a person affiliated with the operator, an external service provider and their affiliates. The most obvious risk to CIS investors in this context is that assets may be purchased (or sold) on behalf of the scheme at an overvalued (or undervalued) price.

- *Transactions using affiliated-party intermediaries*
  This is a situation where the CIS operator enters into transactions with a party that is not affiliated with the operator or external service provider or their affiliates but are entered *through* the use of an affiliated-party intermediary such as agents or brokers. Here, there is a risk to scheme investors that excessive commission or fees will be paid to the affiliated brokers or agents for trading investments of the CIS (either through churning or uncompetitive brokerage rates).

- *Joint transaction with affiliated parties*
  This is a situation where the CIS and its affiliates (such as the operator or the custodian) jointly enter into a principal transaction with a third party.

- *Fees and charges levied by the CIS operator*
  Management fees are intended to cover administration costs incurred by the CIS operator and profits. Conflicts of interest may arise in a number of situations, including:
  - where the CIS operator charges fees based on the performance of the CIS, as there is an incentive to take undue risks with CIS assets in order to increase fees;
  - where the CIS operator or an affiliated external service provider provides administration or accounting services to the CIS, providing an incentive for the CIS operator to charge the highest possible fee and providing the least efficient service; and
  - where the CIS operator and their officers are indemnified out of CIS assets, as this may provide an incentive for the operator to engage in wilful wrongdoing, or act recklessly in disregard of the interests of the CIS.

- *Use of CIS assets for marketing the CIS*
  The expenditure of CIS assets in order to promote the CIS so as to attract new business may cause conflicts of interest where, for example, the fee structure of the CIS operator is a function of the volume of assets under management.

- *Trading on own account*
  Where the CIS operator or employees of the CIS operator are permitted to trade on their own accounts, conflicts of interest may lead to the CIS operator or its employees 'front-running', ie using price sensitive information to allocate favourable trades to their personal account and less favourable or unfavourable trades to the CIS.

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[181] IOSCO, *Conflicts of Interests of CIS Operators*, above n 74.
[182] Affiliated party is used here in its broad, generic sense. Under the *Corporations Act 2001* (Cth), the terms 'related party' and 'associate' have very technical and complex meanings.

- *Selection of directors and external service providers who are favourable to the CIS operator*
  Conflicts of interest may arise where a CIS operator has a discretion when appointing directors and custodians as the CIS operator may have an incentive to appoint persons or organisations that are more likely to make decisions favourable to the CIS operator rather than act in the best interests of the CIS.

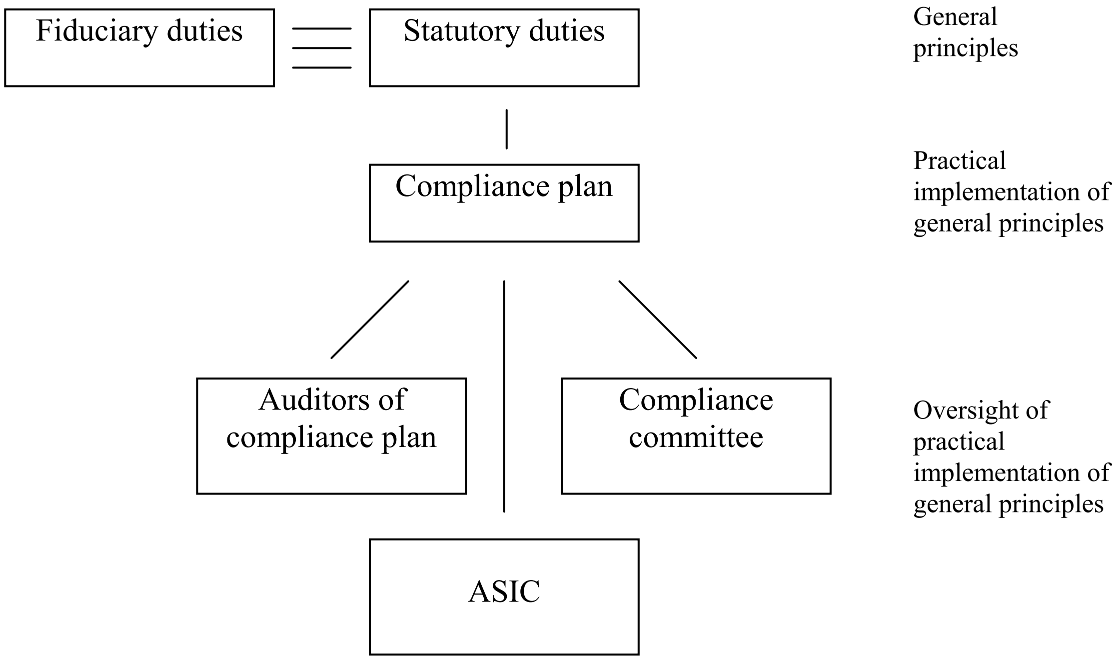
According to IOSCO Principle 6, the regulatory regime should address these risks by ensuring that the exercise of management responsibilities reflects the best interests of investors. The Principle suggests a number of acceptable regulatory responses to dealing with conflict of interest scenarios, including:

(a) through reliance on the concept of 'fiduciary responsibility' as interpreted by the relevant domestic law;
(b) detailed regulations designed to monitor potential conflicts between the CIS operator and investors;
(c) direct prohibition under the law;
(d) disclosure to investors; and
(e) independent review of the conduct of CIS operators by a third party.

The principal means by which the *Corporations Act 2001* (Cth) regulates conflict of interest scenarios is through an overriding principle of fiduciary responsibility, buttressed by equivalent (or near equivalent) statutory duties. This is the first tier of regulation. The implementation and practical adherence to these duties is sought to be achieved through the requirement for a scheme to have a compliance plan, which must set out 'adequate measures that the responsible entity is to apply in operating the scheme to ensure compliance with this Act and the scheme's constitution'.[183] This is the second tier of regulation. The third tier of regulation of conflicts of interest is an overseer requirement. The adequacy and effectiveness of the compliance plan is assessed on an ongoing basis by a compliance committee,[184] and assessed on a periodic basis by the auditor of the compliance plan. To a lesser extent, ASIC also acts as overseer of the compliance plan at the initial scheme registration stage. The three-tiered approach to the regulation could be viewed diagrammatically as follows:

[183] *Corporations Act 2001* (Cth) s 601HA.
[184] Or, in the absence of the obligation to have a compliance committee, by the board of directors of the RE, the majority of which must be 'external directors'.

Figure 11: Tiered approach to regulation



2.7.1 Fiduciary and statutory duties (Tier 1)

As the RE holds scheme property on trust for scheme members,[185] it stands in a fiduciary relationship to them. Although the main indicia of a trust is that the trustee holds legal title to property for the benefit of another (the beneficiary), the fact that the RE has engaged a custodian to hold scheme property (a common scenario for public unit trusts) does not alter the characterisation or extent of the fiduciary duty owed by the RE to scheme members. However, the engagement of a custodian to hold scheme property (and perform other services related to the operation of the scheme) may, if the necessary fiduciary indicia are present, ground a finding that fiduciary duties are owed by the custodian to scheme investors.[186]

There are two fundamental fiduciary principles dealing with conflicts of interest: the 'no conflicts' rule and the 'no profit' rule.

Under the no conflicts rule, a fiduciary is not permitted to 'enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect.'[187] This is augmented by a statutory duty imposed on the RE to act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests.[188]

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[185] *Corporations Act 2001* (Cth) s 601FC(2).
[186] See above Part 2.3.
[187] *Aberdeen Rail Co v Blaikie Brothers* (1854) 1 Macq 461; [1843–60] All ER Rep 249, 252 (Lord Cranworth LC).
[188] *Corporations Act 2001* (Cth) s 601FC(1)(c). An equivalent statutory duty is imposed under s 601FD(1)(c) on officers of the RE. Under the statute, this duty is owed to scheme members. The statute therefore overrides the equity law principle that an officer of a trustee company is not under a

Consistent with IOSCO Principle 6, it should be noted that the statutory duty in s 601FC(1)(c), in contrast to the fiduciary duty, is not a duty to *avoid* conflicts of interest; it is a duty to prefer members' interests over its own in the event of a conflict of interest. Both the international principles and Australian domestic law recognise that conflicts of interest between the operator of the scheme and the scheme's investors are inevitable.[189]

Under the no profit rule, 'a trustee must not abuse his position by making it a means of profit or benefit to himself or a third party'.[190] Again, this is augmented by a statutory duty imposed on the RE to 'not make use of information acquired through being the RE in order to (i) gain an improper advantage for itself or another person; or (ii) cause detriment to the members of the scheme'.[191]

It should also be noted that, while the statutory duties cannot be excluded by the scheme's constitution, some of the fiduciary duties at general law can be so excluded. Hanrahan suggests that a scheme's constitution can exclude the no profit and no conflict rules under equity law, other than the rule prohibiting misuse of information.[192]

The application of general, over-arching fiduciary principles as supplemented by statutory duties is the principal reason why many of the conflict of interest scenarios described above are not expressly prohibited. For example, there is *no* express prohibition in the *Corporations Act 2001* (Cth) against:

- principal transactions with affiliated parties or transactions using affiliated agents or brokers. Indeed a RE is expressly authorised to acquire and hold scheme assets, provided the transaction is at arm's length and subject to terms and conditions that would not disadvantage other scheme members;[193]
- using affiliated parties as external service providers;[194] or
- allowing the RE or its employees to trade on their own account. However, employees of the RE are under a statutory duty not to make use of information or

fiduciary duty to the beneficiaries of the trust as stated in *Australian Securities Commission v AS Nominees Ltd* (1995) 18 ACSR 459.

[189] The drafting of the statutory duty in s 601FC(1)(c) of the *Corporations Act 2001* (Cth) was a response to a number of submissions which expressed the view that, because conflicts of interests between operators and scheme members were inevitable, to impose a duty to avoid conflicts of interest was unrealistic and undesirable: Australian Law Reform Commission, above n 96, [10.8].

[190] R Meagher and W Gummow, *Jacob's Law of Trusts in Australia* (6th ed, 1997) [1742], citing *Stuart v Kingston* (1924) 34 CLR 394, 401 and *Commonwealth v Colonial Combing Co* (1922) 31 CLR 421, 470.

[191] *Corporations Act 2001* (Cth) s 601FC(1)(e). An equivalent statutory duty is imposed under s 601FD(1)(d) on officers of the RE. This duty is owed to scheme members. In addition, officers of the RE owe a statutory duty under s 601FD(1)(e) not to make improper use of their position. These statutory duties imposed on officers are owed to the scheme members.

[192] Hanrahan, supra n 84, [10.17].

[193] *Corporations Act 2001* (Cth) s 601FG.

[194] In relation to the holding of scheme property (custody arrangements), ASIC, *Scheme Property Arrangements*, above n 94, [19] notes that it will not normally require the RE to justify their choice of custodian. Where the RE engages a custodian that is legally or commercially related to it, ASIC states that the types of measures that will be necessary will be the same as that for a self-custody arrangement (ie where the RE is the custodian): at [29].

their position in order to gain an improper advantage for themselves or another or to cause detriment to the scheme.[195]

Under the *Corporations Act 2001* (Cth), the RE's rights to be paid fees and to be indemnified for liabilities or expenses out of scheme property must be set out in the scheme's constitution.[196] Conflicts of interest in relation to these rights are curtailed in that those rights 'must be available only in relation to the proper performance of those duties'.

2.7.3 Compliance Plan (Tier 2)

Although the *Corporations Act 2001* (Cth) on its face does not contain any 'detailed regulations designed to monitor potential conflicts between the CIS operator and investors', the requirement for each scheme to have a compliance plan is intended to serve this purpose.

The legislation prescribes the content of the compliance plan at a generic level, delegating the responsibility for the detail to the RE of the scheme. *ASIC Policy Statement 132*, which deals specifically with compliance plans, goes some way towards providing more detailed regulations, but falls short of providing a checklist.[197] A compliance plan would ordinarily deal with conflict of interest situations such as churning, use of related-party brokers, or purchase or sale of a related party's securities.

2.7.3 Independent third-party review (Tier 3)

The supervision and monitoring of conflict of interest situations is undertaken by the scheme's compliance committee, the auditor of the scheme's compliance plan and, to a lesser extent, ASIC.

Primary responsibility for monitoring conflicts of interest lies with the scheme's compliance committee, the members of which are under a statutory duty of care and diligence.[198] The compliance committee is responsible for, among other things, 'monitoring' the RE's compliance with the compliance plan (suggesting a pro-active role more than a periodic review, although our research tends to suggest that the role being performed by the compliance committee in practice is periodic rather than ongoing).[199] Furthermore, members of the committee are under an obligation to disclose any conflicts of interest that they themselves may have.[200]

The compliance plan must be 'examined' annually by an auditor of the compliance plan for the purpose of auditing the RE's compliance with the plan and expressing an

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[195] *Corporations Act 2001* (Cth) s 601FE.

[196] *Corporations Act 2001* (Cth) s 601GA(2). Any arrangement or agreement (other than the scheme's constitution) that purports to confer on the RE the right to fees or indemnification has no effect.

[197] See the ASIC, *Compliance Plans*, above n 47, annex.

[198] *Corporations Act 2001* (Cth) s 601JD(1)(b).

[199] See above Part 1.6.1.

[200] Members of the compliance committee are also under a statutory obligation to disclose 'direct or indirect pecuniary interests' that they have in a matter being considered by the committee, if their interest could conflict with the proper (independent and objective) performance of their duties and functions: *Corporations Act 2001* (Cth) s 601JJ.

opinion as to whether the compliance plan continues to meet the requirements of the Act.

To a limited extent, ASIC acts as overseer of the RE's approach to managing conflicts of interest. ASIC has the power to refuse to register a scheme under chapter 5C if it appears that the scheme's compliance plan does not meet the requirements of the Act.[201] However, ASIC as a general rule does not approve or 'vet' compliance plans.[202]

2.7.4 Disclosure and approval by investors

Part 5C.7 of the *Corporations Act 2001* (Cth) contains specific rules that are designed to allow scheme members to sanction related-party transactions that would otherwise contravene the Act, the compliance plan or the scheme's constitution.[203]

2.8 Asset valuation and pricing

IOSCO Principle 7 states that the regulatory regime must provide for a system for valuation of CIS assets, pricing of interests and procedures for entry to and exit from the CIS, which is fair to existing and potential investors. The Principle further states that the price of interests must be calculated according to the net asset value of the CIS based on an accepted accounting standards.

The *Corporations Act 2001* (Cth) adopts a non-prescriptive approach by imposing a statutory duty on the RE to ensure that scheme assets are valued at regular intervals appropriate to the nature of the property.[204] The systems or approach for valuing scheme investments and calculating unit price must be set out in the scheme's compliance plan.[205] As discussed above, the adequacy of the plan is to be assessed at regular intervals by the compliance committee (if one exists) and less regularly by the compliance plan auditor.

Standards and guidelines on valuation and pricing have also been issued by the Investment and Financial Services Association ('IFSA').[206]

Entry into the scheme (acquisition of interests) must be adequately provided for in the scheme's constitution.[207] ASIC interprets this to mean that the constitution must provide for an 'independently verifiable price'.[208]

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[201] *Corporations Act 2001* (Cth) s 601EB(1).
[202] However, in order to assist industry participants in drafting compliance plans that meet the requirements of the Act, ASIC published in March 2000 a series of commentaries on compliance plans received by ASIC: see above n 36.
[203] Part 5C.7 of the *Corporations Act 2001* (Cth) and reg 5C.7.01 of the *Corporations Regulations 2002* (Cth).
[204] *Corporations Act 2001* (Cth) s 601FC(1)(j). Neither the Act nor any ASIC Policy Statement provide guidance as to the meaning of 'regular intervals appropriate to the nature of the property'. However, it is industry practice for cash management and equity trusts to be valued daily, with property trusts and agricultural schemes valued at far less frequent intervals.
[205] *Corporations Act 2001* (Cth) s 601HA(1)(c).
[206] IFSA, *Incorrect Pricing of Scheme Units*, Guidance Note 04.00 (1999); IFSA, *Scheme Pricing*, Standard 08.00 (1999); IFSA, *Valuation of Scheme Assets and Liabilities*, Standard 09.00 (1999).

2.8.1 Withdrawal rights

Withdrawal rights (the right of a scheme member to redeem the investment) are not mandatory under Australian law. This departs from IOSCO Principle 7.2.1, which appears to be premised on a mandatory redemption facility[209] and departs also from the former prescribed interest regime.[210]

In certain cases, withdrawal rights are expressly prohibited. Trusts that are listed on the ASX are not permitted to offer continuous withdrawal facilities in the scheme's constitution,[211] although on-market buy-backs of units may be permitted in certain circumstances.[212] The rationale for this prohibition is to prevent the number of units in the trust being reduced to a level that affects the ability of the remaining unit holders to trade, which in turn may jeopardise the ability of the scheme to continue operations. Being listed, investors are able to more easily sell their interests on-market, hence reducing the justification for withdrawal rights.

The primary rationale for not requiring compulsory redemption facilities is the expectation that market forces would reduce the possibility that scheme operators would lock in investors by not offering redemption facilities.[213]

Under chapter 5C of the *Corporations Act 2001* (Cth), scheme members only have a right to withdraw if the scheme's constitution provides for withdrawal. If the scheme's constitution provides a right to withdraw, then it must:

- specify the withdrawal right; and
- set out adequate procedures for making and dealing with withdrawal requests.[214]

Different rules apply depending on whether the right may be exercised while the scheme is liquid or not liquid. If the right may be exercised while the scheme is liquid,[215] then the procedures in the scheme constitution must be followed.[216] If the right may be exercised while the scheme is not liquid, then the procedures in the scheme's constitution and the Act (particularly ss 601KB–601KE) must be followed.[217]

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[207] *Corporations Act 2001* (Cth) s 601GA(1)(a).
[208] ASIC, *Managed Investments: Constitutions*, Policy Statement 134 (2000) [19]. Class order relief is available from this requirement where for commercial reasons, the consideration to acquire an interest cannot be determined independently: ASIC, *Class Order 98/52* (1998).
[209] Principle 7.2.1 states that 'a CIS must redeem its units at the request of any investor, in a manner and frequency laid down in the law or the CIS rules': IOSCO, *Report on Investment Management*, above n 71.
[210] Under former div 5 of pt 7.12 of the *Corporations Law*, an approved deed for a prescribed interest undertaking was required to include a buy-back covenant under former s 1069(1)(c).
[211] *ASX Listing Rules*, rule 1.1, condition 5 states that 'if the entity is a trust … the responsible entity must not be under an obligation to allow a security holder to withdraw from the trust'.
[212] *ASX Listing Rules*, rule 7.36.
[213] Australian Law Reform Commission, above n 96, [7.22].
[214] *Corporations Act 2001* (Cth) s 601GA(4).
[215] A scheme is taken to be liquid if at least 80% of the value of scheme's assets is cash, bank accepted bills or marketable securities: *Corporations Act 2001* (Cth) s 601KA(4)–(6).
[216] *Corporations Act 2001* (Cth) s 601KA(3)(a).
[217] *Corporations Act 2001* (Cth) s 601KA(3)(b).

Although the rights, terms and procedures applying to withdrawal are, generally speaking, determined by the scheme operator, the Act requires that the right to withdraw and the accompanying procedures must be fair to all members.[218] Both *procedural* and *substantive* fairness must be observed. Fairness of the redemption or withdrawal price, according to ASIC, depends on appropriate and reasonably current valuations of scheme property and the withdrawal price being independently verifiable based on the terms of the scheme's constitution.[219] The requirement of 'fairness' is consistent with the statutory duty of the RE to act impartially.[220]

IOSCO Principle 7.2.2 states that the redemption of units should only be suspended on a temporary basis. Both the *Corporations Act 2001* (Cth) and ASIC policy are silent on this point, reflecting the general rule that the scope for withdrawal or redemption facilities are to be determined by the RE.

Given that the constitution is legally enforceable as between the members and the RE, it is perhaps surprising that where there are no rights of withdrawal, s 601GA does not expressly require disclosure of this matter in the scheme's constitution. However, disclosure of the absence of withdrawal rights would be necessary for the purposes of complying with the content requirements of the product disclosure statement under which the units must be offered.[221]

2.9 Investment and borrowing limitations

IOSCO Principle 8 states that there should be investment restrictions, portfolio diversification and borrowing limitations that address the investment objectives, risk profile and degree of liquidity required for a CIS to meet redemptions in all market conditions.

It should be noted this Principle is premised, to a large extent, on the existence of a compulsory redemption facility.[222] As noted already, chapter 5C does not impose a mandatory redemption requirement.

The *Corporations Act 2001* (Cth) delegates the scope of the investment and borrowing powers to the scheme's constitution, which must be legally enforceable as between members and the RE.[223]

Investment powers and policy

The investment powers of a RE in relation to a scheme must be set out in the scheme's constitution.[224] It is common for a scheme's investment policy or strategy

[218] *Corporations Act 2001* (Cth) s 601GA(4).
[219] ASIC, *Constitutions*, above n 208, [25].
[220] The duty of impartiality in *Corporations Act 2001* (Cth) s 601FC(1)(d) is a duty to treat the members who hold interests of the same class equally and members who hold interests in different classes fairly.
[221] *Corporations Act 2001* (Cth) s 1031D(1)(f).
[222] See the discussion of IOSCO Principle 7.2.1, above Part 2.8.1.
[223] *Corporations Act 2001* (Cth) s 601GB.
[224] *Corporations Act 2001* (Cth) s 601GA(1)(b).

(as opposed to its powers of investment) to be set out in the disclosure document under which scheme interests are offered to investors.[225]

Borrowing capacity

Any powers conferred on the RE to borrow must be set out in the scheme's constitution.[226]

2.10 Investor rights

IOSCO Principle 9 refers to investors being given 'certain rights in relation to a CIS, which are appropriate to the overall context of CIS regulation', namely:

- the fundamental right of an investor to withdraw funds from the CIS within a reasonable period;
- appropriate access to remedies; and
- for investment companies only,[227] the ability to participate in significant decisions of the company.

As noted in the discussion of IOSCO Principle 7.2.1, chapter 5C of the *Corporations Act 2001* (Cth) does not impose a mandatory redemption requirement and, to this extent, the Australian law cannot be said to conform with the IOSCO Principles.

As the vast majority of managed investment schemes in Australia are structured as unit trusts, the IOSCO Principle in relation to investment companies does not warrant consideration.

The *Corporations Act 2001* (Cth) gives scheme members a number of rights in relation to the operation of the managed investment scheme, many of which are not expressly recognised or even contemplated by the IOSCO Principles. Scheme members have the right to:

- remove and replace the RE of the scheme;[228]
- modify, repeal or replace the scheme's constitution;[229]
- veto certain related-party transactions;[230]
- requisition meetings of scheme members[231] or convene such meetings on their own motion;[232]
- inspect and obtain copies of the register of scheme members;[233]
- inspect the minute books of meetings of scheme members;[234] and

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[225] See Butterworths, *Australian Corporation Law: Principles and Practice*, vol 2, para [7.4.0123].
[226] *Corporations Act 2001* (Cth) s 601GA(3).
[227] These are collective investment schemes structured as companies, most commonly found in Japan, Luxembourg, Mexico, Spain, the United Kingdom and the United States.
[228] *Corporations Act 2001* (Cth) s 601FM. For unlisted schemes, the resolution to remove the RE must be an extraordinary resolution. An extraordinary resolution requires at least 50% of the *total votes* attaching to units to be cast in favour of the resolution.
[229] *Corporations Act 2001* (Cth) s 601GC(1)(a).
[230] *Corporations Act 2001* (Cth) Pt 5C.7.
[231] *Corporations Act 2001* (Cth) s 252B.
[232] *Corporations Act 2001* (Cth) s 252D.
[233] *Corporations Act 2001* (Cth) s 173.
[234] *Corporations Act 2001* (Cth) s 253N.

- wind up the scheme.[235]

Scheme members also have a right of access to both internal and external complaints resolution mechanisms.[236]

Furthermore, investors who have suffered loss or damage because of contravening conduct by the scheme's RE are granted a right of civil action to recover the loss from the RE.[237]

Scheme investors also have the right to rescind contracts to subscribe for interests in the scheme if the scheme is being operated illegally or the offeror is acting in contravention of the product disclosure statement ('PDS') provisions.[238]

These rights are wide-ranging and appear to be premised on two implicit policy assumptions of the *MIA*. First, that scheme members are, or will become, aware of these rights. Secondly, even if scheme investors are aware of the rights, that they will take action to enforce them.

These assumptions are not beyond question. For example, if scheme investors are willing to relinquish day-to-day control of their investment portfolio to an investment manager — the essence of a managed investment scheme — is it not reasonable to assume that they would adopt the same approach to the enforcement of at least some of their rights?

Section 601MA is a prime example. The grant of a direct cause of legal action to scheme members is premised on a number of flaws relating to both the *MIA* itself and how it operates in practice. The primary flaw is that there is no means by which scheme members can become aware that the RE has 'contravened a provision of this Chapter'. Neither the board nor the compliance committee of the RE is under an obligation to report or disclose contraventions (material or otherwise) to scheme members. The auditor of the compliance plan would be expected to identify compliance or other regulatory breaches, but the compliance plan auditor is required to report only to the RE itself[239] and, in some circumstances, to ASIC.[240] There is no requirement to send a compliance plan audit report to scheme members (in direct contrast to audit reports on financial statements under chapter 2M). There is also no

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[235] *Corporations Act 2001* (Cth) ss 601NB, 601NE(1)(b).

[236] These dispute resolution mechanisms must be set out in the scheme's constitution: *Corporations Act 2001* (Cth) s 601GA(1)(c). See ASIC, *Constitutions*, above n 208, [23].

[237] *Corporations Act 2001* (Cth) s 601MA. Civil action may be taken whether or not the RE has been convicted of an offence, or had a civil penalty order made against it.

[238] *Corporations Act 2001* (Cth) s 601MB. Scheme investors are also given rights in relation to the 'point of sale' offering of interests in the scheme. Under the financial product disclosure provisions in Pt 7.9 of the Act, scheme members have the right to:

- where the product disclosure statement is defective, return the financial product and have any money they paid to acquire the product repaid (s 1016F);
- return the product during the mandatory 14 day 'cooling-off' period (s 1019B); and
- bring civil recovery proceedings to recover loss or damage arising from acquiring an interest in a managed investment scheme through a product disclosure statement that was defective as to content or was given to the investor at the wrong time (s 1022B).

[239] *Corporations Act 2001* (Cth) s 601HG(3).

[240] *Corporations Act 2001* (Cth) s 601HG(4), (7).

requirement for schemes to hold annual general meetings[241] and scheme investors have no power to requisition meetings of the scheme unless a specific resolution is proposed for this purpose.[242]

The second flaw is that it assumes that scheme investors will have sufficient resources and inclination to bring a civil recovery action against the RE. In relation to non-institutional scheme members, this is unrealistic given that in Australian civil proceedings, costs follow the event and thus the risk of an unsuccessful action is likely to be prohibitive to implementing proceedings. The risk of an unsuccessful action would not necessarily be prohibitive to institutional scheme investors, however, these investors may be more likely to sell down or redeem holdings[243] rather than commence legal proceedings against the RE. The reality is that many investors — or at least those that the *MIA* is designed to protect — will turn to ASIC to initiate proceedings on their behalf. However, as noted earlier in this report, with limited resources and increasing responsibilities,[244] ASIC may not always be able to enforce investors' rights adequately.

The power under s 601FM to remove a RE and replace it with another is similarly limited; it is a power or right that is difficult to utilise. The majority of scheme investors may opt for the easier (and possibly less costly) option to liquidate or redeem their investment. In any case, even if the right were to be invoked, its chances of success are highly unlikely due to the high voting threshold — an extraordinary resolution is required to remove a RE of a scheme that is unlisted.[245] Given that the overwhelming majority of schemes are not listed, this means that extraordinary resolutions are required to remove a RE for over 97% of the entire industry.[246] This high threshold may also have the undesirable effect of facilitating under-performing REs to entrench their positions. Without the support of an institutional shareholder with a substantial unitholding, the resolution is unlikely to be passed.

Nevertheless, it is accepted that a RE, having invested much time and expense in obtaining a licence, establishing a compliance plan and a compliance committee and the like, should be able to operate with some degree of security of tenure. The appropriate voting threshold remains a vexed question.[247] Irrespective of the

[241] There are good reasons for the inappropriateness of an annual general meeting ('AGM') for managed investment schemes. The most commonly cited reasons are that the expense of convening and holding AGMs for schemes outweighs any benefits (annual reports being a more cost-effective way of disseminating information), anticipated lack of investor interest and that schemes do not have the same need for AGMs as do companies (for which AGMs are required to elect directors and declare dividends): see Australian Law Reform Commission, above n 96, [11.24].

[242] The *Turnbull Review* has recommended that scheme members be given the power to requisition a scheme meeting without having to propose a resolution at that meeting, a similar power to that which applies to companies under s 249D of the *Corporations Act 2001* (Cth): *Turnbull Review*, above n 1, recommendation 7.

[243] Whether redemption is allowed depends on the scheme's constitution. See *Corporations Act 2001* (Cth) Pt 5C.6.

[244] Consider the impact of the *Financial Services Reform Act 2001* (Cth).

[245] Furthermore, it should be noted that ss 601FL (retirement of RE) and 601FM (removal of RE) are the only sections of the *Corporations Act 2001* (Cth) that require an extraordinary resolution.

[246] As at 30 September 2001, there were 71 listed trusts, not all of which would be managed investment schemes. This represents less than 3% of the total number of registered managed investment schemes.

[247] One of the recommendations of the *Turnbull Review* was that the voting threshold for removal of the RE of a unlisted scheme should be either a special resolution or a hybrid resolution (special

appropriate voting threshold, it is submitted that the power to remove the RE represents a 'back stop' corporate governance mechanism rather than a 'front line' mechanism, the latter being far more important if the soundness of corporate governance is to be measured by the degree to which investors rights and interests are protected.

2.11 Marketing and disclosure

IOSCO Principle 10 states that there must be 'full, accurate and timely' disclosure to prospective investors so as to enable an investor to make an informed investment decision in relation to a CIS. In addition, the Principle requires that financial and other information relating to the management and operation of the scheme must be provided on a regular basis for the benefit of both existing and prospective investors.

Australian law meets the IOSCO Principles.

The 'prospectus content rules' of the IOSCO Principles require, among other things, that the disclosure document must contain all material information which investors would reasonably require and reasonably expect to form an informed investment decision. The Australian application of this general disclosure test is found in chapter 6D,[248] which applies to prospectuses and other disclosure documents.[249]

Until 11 March 2002, the prospectus content rules applied equally to offers of shares and to offers of interests in managed investment schemes. This position has now changed; the prospectus provisions no longer apply to offers of interests in managed investment schemes.[250]

Offers of scheme interests must be made through a PDS, which must contain certain information that a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire an interest in the scheme, including information concerning:

- significant characteristics or features of the investment or of the rights, terms, conditions and obligations attaching to it;
- significant risks associated with holding the scheme investment;
- costs and ongoing payments that may be required;
- fees, expenses and charges that may impact on returns; and
- significant taxation implications.[251]

These information requirements are expanded by s 1013E, which requires disclosure of any other information that might reasonably be expected to have a material

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resolution with an added requirement that the total votes cast must constitute at 25% of the total votes of scheme members): *Turnbull Review*, above n 1, recommendation 2.

[248] The general disclosure test for prospectuses is found in s 710 of the *Corporations Act 2001* (Cth).

[249] Offer information statements and profile statements are subject to different content disclosure rules under ch 6D of the *Corporations Act 2001* (Cth).

[250] Under the *Financial Services Reform Act 2001* (Cth), the definition of 'securities' was amended to exclude interests in registered managed investment schemes. The fundraising provisions in ch 6D of the *Corporations Act 2001* (Cth) have application only to offers of securities.

[251] *Corporations Act 2001* (Cth) s 1013D.

influence on the investor's decision as to whether to acquire the product, but are then qualified by s 1013F, which states that information is not required to be included in the PDS if it would not be reasonable for the retail investor to expect to find the information there.

Thus, the disclosure rules applying to PDSs are equally as robust as those that apply to prospectuses and, with the requirement to specifically address the matters bulleted in the list above, arguably more useful to prospective scheme investors for decision-making purposes.

This 'point of sale' disclosure is supplemented by two forms of periodic disclosure. First, periodic statements must be sent annually (or more frequently at the discretion of the issuer) to scheme investors and must disclose information that will enable the holder to understand his or her investment in the scheme, including a summary of all transactions in relation to the holding during the reporting period, indicating the nature and purpose of those transactions.[252] Secondly, scheme investors must be sent annual financial reports, prepared in accordance with the applicable standards and duly audited, of the scheme under chapter 2M.

[252] *Corporations Act 2001* (Cth) s 1017D.

Part 3: Conclusions and observations

The research conducted for the purposes of this report is based on information, attitudes and behaviour that, to a large degree, continue to reflect the industry's transition to the *MIA* regime. The continuing growth and, to a lesser extent, diversity of the managed investments industry will continue to test both the ability of the law to regulate the industry and the ability of the industry to regulate itself.

The strong point of the *MIA*, and the administrative regime that supplements its operation, is the licensing regime administered by ASIC. The importance of the licensing regime should not be understated. The Australian licensing regime is a rigorous system that goes a long way toward the prevention or the minimisation of the risk of fraud, maladministration and negligence. This is reflected in the requirements relating to operational capacity, reporting lines, competency standards for key personnel (responsible officers), and the power of ASIC to refuse to register a scheme on the basis of an inadequate compliance plan. It accords with international principles for the governance of collective investment schemes. Nevertheless, licensing, by its very nature, must be recognised as a 'point in time' assessment by the regulatory authority.

However, Australian law is deficient by international standards in not mandating a requirement for an independent custodian to hold scheme assets. To permit self-custody and related-party custody introduces a higher risk of maladministration. This heightened compliance risk may not be sufficiently counterbalanced through the other protective and supervisory mechanisms that currently exist under the *Corporations Act 2001* (Cth). However, our research suggests that external, independent custodians are predominantly used within the industry. This could be attributable to reputational or logistical/operational factors, licensing conditions or some 'carry-over' effect from the former two-party structure. With the increasing concentration of the industry, particularly in the area of financial asset schemes, it is foreseeable that this trend might change over time, with mergers and acquisitions generating greater self-custody and related-party custodial arrangements.[253] Even where external, independent custodians are being used, the role being performed by custodians is not fiduciary in character and extends only to holding scheme assets and acting on the instructions of the RE.

A limitation of the *MIA* lies in the ongoing regulation and supervision of the scheme and its operator. Public sector supervision is hampered by financial restraints and private sector supervision has been restricted by the legislation. ASIC has conceded that its current ability to supervise the entire industry is limited. The selective scope of its surveillance activities to date is testament to this limitation. In the absence of additional regulatory resources, it seems self-evident that ASIC's capacity to provide an effective check on an industry that is rapidly growing (both in absolute size and diversity) will diminish even further over time.

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[253] An analysis of changes in custodial arrangements over time would be a worthy subject for research.

Similarly, there is no truly independent private entity that provides an effective 'real-time' check on the RE. The primary operational monitoring and supervision of the activities of the RE lies with the RE itself. The internalisation of compliance and compliance monitoring is not objectionable per se; to the contrary, it is a laudable objective and outcome. The imposition of statutory duties on the RE, coupled with compliance plans, were expected to force operators to improve compliance practices, to more fully appreciate the inherent conflicts of interest that are involved in operating a scheme and to devise procedures and systems to manage these conflicts. Of the surveys and interviews conducted for the purposes of this research report, we have formed the view that compliance and compliance monitoring are being more thoroughly embraced by the primary compliance areas of the RE.

Apart from ASIC's 'watchdog' role, the *MIA* does provide for two other forms of external 'watchdog' oversight: the compliance committee (or an equivalent independent board) and the compliance plan auditor. That both are considered necessary reflects an implicit admission that self-monitoring by the RE is not of itself an effective governance policy.

The very existence of a compliance committee does force a RE to be more accountable for establishing and maintaining compliance systems; without a compliance committee to report to on a regular basis, the RE would be prone to become lax in the implementation and supervision of compliance systems. However, while compliance committee members are under statutory duties to act honestly and with care and diligence, they are not under a duty to act in the best interests of investors;[254] their allegiance is owed to the entity that they are expected to supervise. Furthermore, our research indicates that:

- compliance committees most commonly meet every quarter and are substantially (and often totally) dependent on reporting from internal officers (the primary compliance organs) of the RE, thereby substantially undermining their ability to be pro-active and a source of 'real-time' intervention;
- there is variable quality of compliance committees, a result that derives from there being no minimal qualifications, training or experience pre-requisites; and
- the large pool from which compliance committee membership may be drawn and membership tenure being determined by the RE (and not subject to veto by either ASIC, scheme members or the compliance plan auditor), gives unjustifiable latitude to the RE.

The *MIA* provides scheme investors with a range of black-letter law rights, such as the right to bring a civil action and recover for losses caused by contraventions, the right to remove a RE without reason and the right to requisition a scheme meeting. However, many of these may not be of practical benefit due to logistical and financial hurdles. For example, a scheme member who suffers loss or damage as a result of a contravention of the *Corporations Act 2001* (Cth), the compliance plan or the scheme's constitution has the right to bring a civil action against the RE, but neither the RE, the compliance committee nor the compliance plan auditor is under an obligation to report contraventions to scheme members. Scheme members also have

[254] The RE itself and officers of the responsible are under statutory duties to act in the best interests of scheme investors: *Corporations Act 2001* (Cth) ss 601FC(1)(c), 601FD(1)(c).

no means by which they can ask questions of the board, management, the compliance committee or the compliance plan auditor.

Our research also indicates that, for some fund managers, the regulatory regime under chapter 5C did not radically alter the behaviour and practices that existed within the industry; it merely formalised what was already happening in practice.

> *It was certainly formalised as we had to put in an actual compliance structure. Previously, there was no-one person charged specifically with the responsibility of compliance — and now there is ... But everybody used to have and still does have an obligation to report breaches of the constitution or the compliance plan. But now there's lots of layers of regulations, compliance plan obligations as well that previously people would have thought 'well, it is not really material that needs to be reported' but now I expect every breach of the compliance plan to be reported to me and then I report that to the committee.*
>
> Compliance Manager of a RE with funds under management of greater than $250 million, operating over 40 financial asset schemes.

> *I can sum up the major difference between the two periods and that is that previously they did the same thing and I don't think they did anything significantly different at all — they just didn't write it all down ... What happens behind the scenes as far as recording is concerned and the structure of that recording is the only material difference ... It didn't change the practice I would suggest very much at all. It just changed the thought process of compliance.*
>
> Compliance Manager of a RE with funds under management of less than $50 million, operating one mortgage investment scheme.

> *The level of detail in the reporting and level of actual compliance is much higher than what it was previously. Even the detail in compliance plans is a lot more prescriptive, more highly detailed, and there is a lot more focus on meeting all of the compliance requirements absolutely stringently ... For this particular responsible entity, it just merely formalised what they were currently doing. The actual area of operation of this responsible entity in the financial services field means that it operates in a sector of the financial services industry that is the most heavily regulated of all in addition to* MIA *responsibilities. Having previously acted as a compliance committee member for a different responsible entity and compliance manager for other responsible entities, in the past was a lot less rigorous in some sectors of the financial services industry prior to the introduction of the* MIA.
>
> Compliance Manager of a RE with funds under management of between $50–$250 million, operating seven schemes (a mixture of financial assets, property and mortgages).

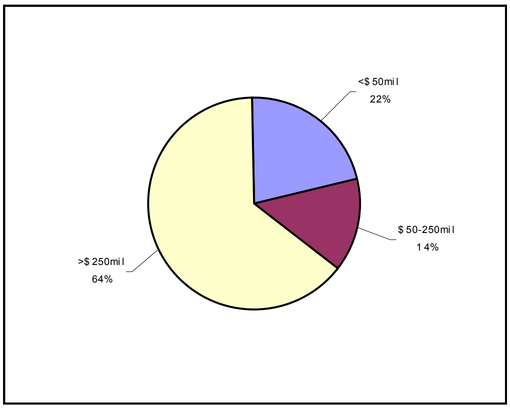
> *The company has always had a strong documentation culture. The* MIA *resulted in reinforcing what we were attempting to create.*
>
> Compliance Manager of a RE with funds under management of less than $50 million, operating one primary production scheme.

The other notable feature of the managed investments industry is the trend towards specialisation of functions, reflected in the level of outsourcing of the custodial and investment management function. The monitoring of external service providers continues to be a problem for sections of the industry.

Appendices

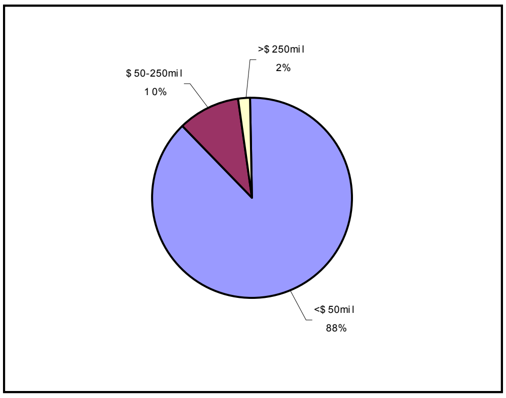
Appendix 1: Funds under management

Financial assets



Sample size: 101.
Number of REs for which funds under management unknown: 61.

Primary production



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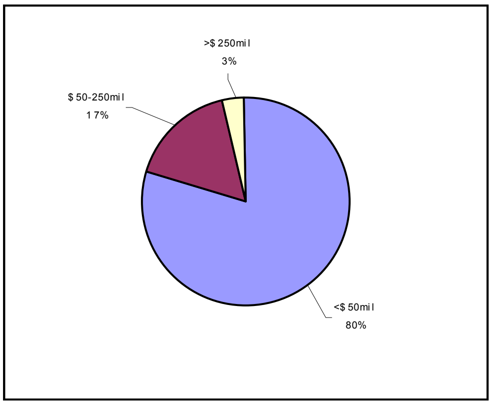
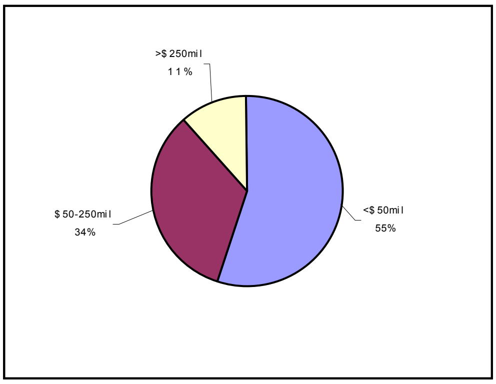
Number of REs for which funds under management unknown: 63.

Mortgages



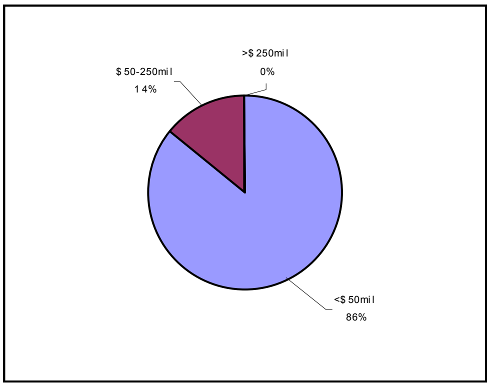
Sample size: 58.
Number of REs for which funds under management unknown: 15.

Property



Sample size: 53.
Number of REs for which funds under management unknown: 19.

Strata



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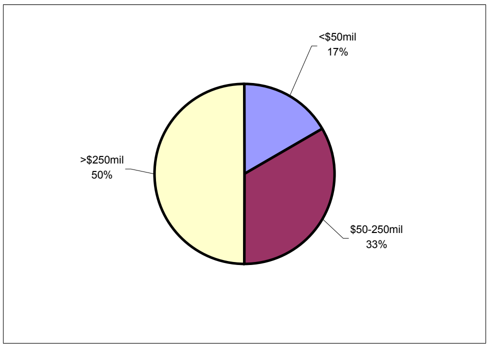
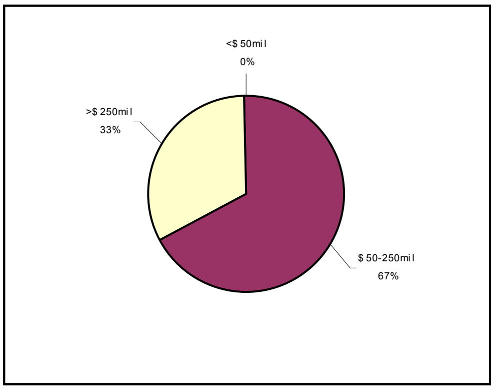
Number of REs for which funds under management unknown: 6.

Other



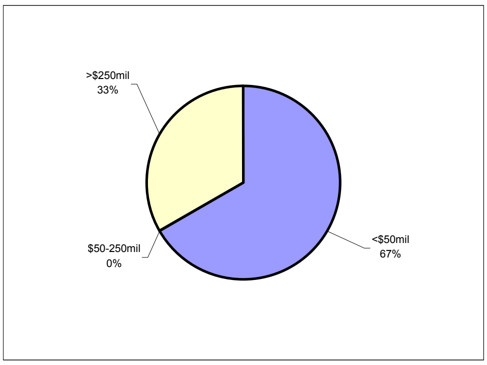
Sample size: 6.
Number of REs for which funds under management unknown: 1.

IDPS



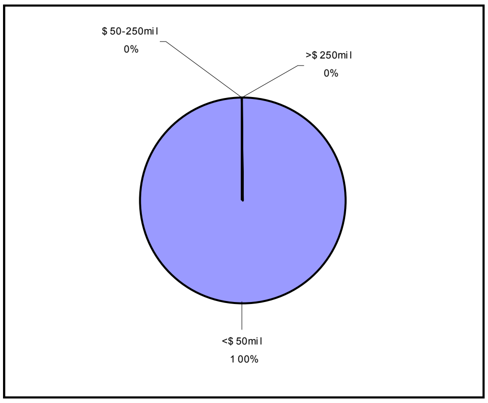
Sample size: 3.
Number of REs for which funds under management unknown: 3.

Film



Sample size: 3.
Number of REs for which funds under management unknown: 3.

Masterfunds



Sample size: 1.
Number of REs for which funds under management unknown: 0.

Appendix 2: The ownership structure of responsible entities across industry sectors

Ownership structure	*Financial assets*	*Primary production*	*Mortgages*	*Property*	*Strata*	*Other*	*IDPS*	*Timeshare*	*Film*	*Masterfunds*
Wholly-owned subsidiary	97	19	1	9	1	1	4	1	0	0
Privately-owned	7	3	1	1	0	0	0	0	0	1
50% subsidiary	1	0	0	1	0	1	0	0	0	0
Shareholders of related entity	1	0	20	0	0	0	0	0	0	0
Listed public company	4	0	0	0	0	0	0	0	0	0
Joint venture	0	0	0	0	0	0	0	1	0	0
Total known	110	22	22	11	1	2	4	2	0	1
Unknown	52	90	51	61	12	5	2	3	3	0
TOTAL	162	112	73	72	13	7	6	5	3	1

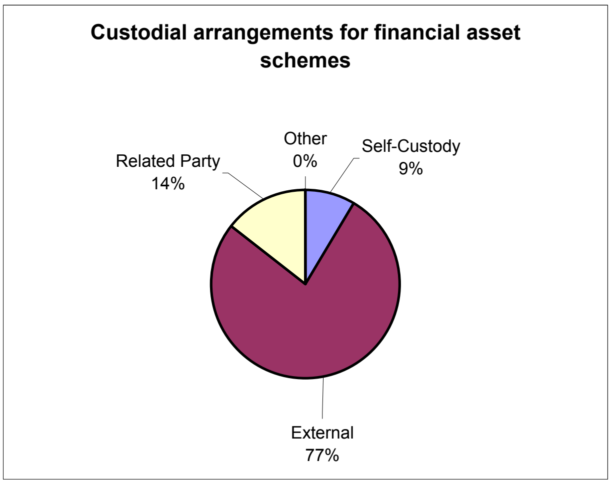
Appendix 3: Use of compliance committee per scheme type

	Use compliance committee					***Do NOT use compliance committee***					***Compliance committee use unknown***					
	Funds under management of the responsible entity					Funds under management of the responsible entity:					Funds under management of the responsible entity					
	< $50 million	$50–$250 million	> $250 million	Unknown	**TOTAL**	< $50 million	$50–$250 million	> $250 million	Unknown	**TOTAL**	< $50 million	$50–$250 million	> $250 million	Unknown	**TOTAL**	**GRAND TOTAL**
Financial assets	55	68	755	199	1077	3	0	115	73	191	17	22	291	303	633	1901
Primary production	45	3	3	51	102	13	1	0	10	24	39	12	0	40	91	217
Mortgages	30	9	12	10	61	12	1	0	4	17	6	2	1	7	16	94
Property	85	81	10	12	188	6	0	6	1	13	8	4	0	27	39	240
Strata	22	0	0	9	31	0	0	0	0	0	1	1	0	8	10	41
Other	2	0	0	1	3	0	1	1	0	2	1	1	0	0	2	7
IDPS	0	8	0	3	11	0	0	0	0	0	0	0	2	2	4	15
Timeshare	0	0	0	4	4	0	0	0	0	0	0	0	0	1	1	5
Film	3	0	0	0	3	0	0	0	0	0	0	0	0	6	6	9
Masterfunds	1	0	0	0	1	0	0	0	0	0	0	0	0	0	0	1
TOTAL	243	169	780	289	1481	34	3	122	88	247	72	42	294	394	802	2530

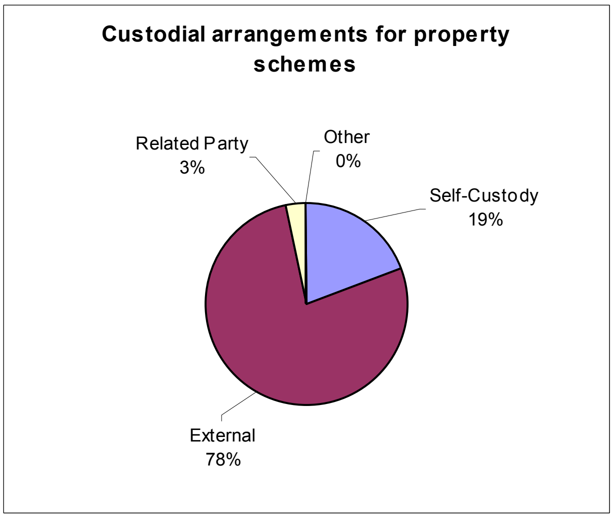
The figures in the table represent number of schemes. Funds under management relates to the responsible entity that operates the scheme.

Appendix 4: Custodial arrangements for major industry sectors

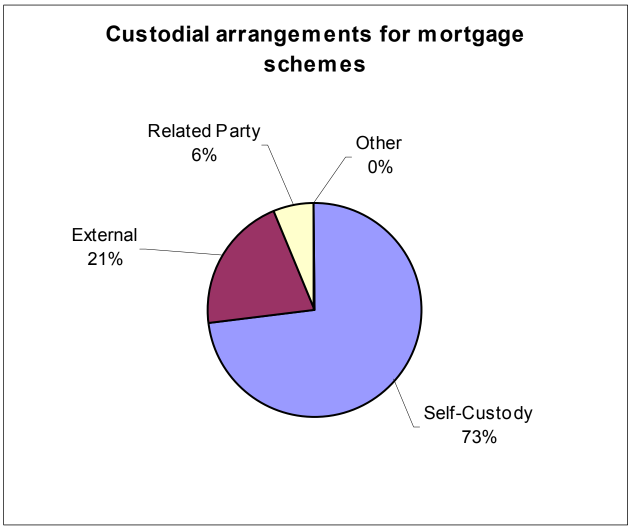
Financial assets



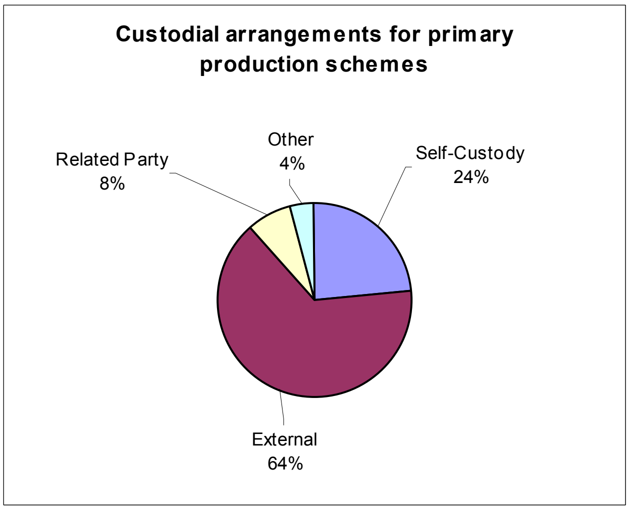
Property



Mortgage



Primary production



Appendix 5: Custodial arrangements per responsible entity[255]

	Funds under management			
	< $50 million	$50–250 million	> $250 million	Unknown
Financial assets				
Self-custody	0	0	4	2
External	14	8	20	11
Related party	1	1	4	4
Other	0	0	0	0
Unknown	7	5	37	44
Primary production				
Self-custody	5	1	0	6
External	16	0	1	16
Related party	1	0	0	3
Other	0	0	0	2
Unknown	21	4	0	36
Mortgages				
Self-custody	18	1	0	5
External	5	1	0	1
Related party	1	1	0	0
Other	0	0	0	0
Unknown	22	7	2	9
Property				
Self-custody	4	2	0	0
External	11	6	4	3
Related party	1	0	0	0
Other	0	0	0	0
Unknown	13	10	2	16

[255] This data does not include REs that operate strata, IDPS, timeshare, film, Masterfunds or Other schemes. These excluded sectors comprise less than 8% (by number) of REs. REs operating schemes classified as financial assets, primary production, mortgage and property comprise over 92% (by number).

Appendix 6: Review of the Managed Investments Act 1998 by Malcolm Turnbull: Summary of recommendations

Investor protection

Members' rights to remove and replace the responsible entity

Recommendation 1

Changes of a scheme's RE should be effective only if made in accordance with Division 2 of Part 5C.2, and provisions of a scheme's constitution relating to the removal and replacement of a scheme's RE should not override the legislation in any circumstances.

Recommendation 2

For unlisted schemes, the current requirement for an extraordinary resolution to remove or appoint a RE should be replaced with either (but not both) of the following two alternatives:

- a special resolution (that is, 75 per cent of the votes cast at a meeting); or
- a special resolution with the added requirement that the votes cast in favour of that resolution must constitute at least 25 per cent of the total votes of scheme members.

Further consultation should take place on which of these alternatives would be preferable.
For listed schemes, the legislation should clarify that the appointment or removal of a RE requires an ordinary resolution.

Alternative qualifications for temporary responsible entities

Recommendation 3

Official liquidators should be included as entities which can be temporary REs to widen the pool of suitable candidates and lessen delays in the appointment of temporary REs.

Protection of scheme property

Recommendation 4

ASIC should have administrative powers to make binding orders for the protection of scheme property. ASIC should be able to exercise these powers at any time following the revocation or cancellation of a RE's licence, or the removal of a RE (whether by members or ASIC), and pending the appointment of a temporary RE.

The scheme's constitution

Recommendation 5

ASIC should have powers to:

- amend or remove a constitutional provision; and
- require a provision to be inserted into a constitution,

only to the extent needed to ensure that the constitution would comply with any applicable law.

The legislation should be amended to provide that the constitution of a scheme:

- must not contain a provision that is contrary to or inconsistent with any applicable law; and
- is enforceable (excluding any unlawful provisions) between the members and the RE by virtue of the Corporations Act.

Recommendation 6

Section 601 GA should:

- be clarified to remove any ambiguity pertaining to the payment of fees or a right to an indemnity claimed by a RE. This includes the clear application of ‘in relation to the performance of its duties’ to both ‘rights to be paid fees out of scheme property’ and to ‘be indemnified out of scheme property for liabilities or expenses incurred’;
- expressly prohibit the payment of fees or a right to an indemnity where the timing of payment or the entitlement is linked to a change in the RE;
- ensure that payment of fees or a right to an indemnity cannot be claimed in advance of a RE’s proper performance of its duties; and
- exclude any person other than the RE having any right in respect of scheme property or against members for fees or an entitlement to an indemnity for services provided to the scheme.

Members’ rights to call general meetings

Recommendation 7

Provision should be made in the legislation for members to request the RE of a registered scheme to call a general meeting. The amendment could be based on section 249D which applies to the calling of general meetings by directors of a company on the request of members.

REs should be required to inform members in their schemes’ annual reports of members’ rights to requisition meetings.

Voting rights of scheme members

Recommendation 8

ASIC should have a discretion to vary the voting rights of members of schemes where it is intended by the scheme that members’ voting rights will not be proportionate to their capital contributions.

The amendment should be drafted so as to ensure that the protection of scheme members and the ability of the RE to properly perform its duties will not be compromised.

Members' rights to withdraw from schemes

Recommendation 9

The types of contracts which are voidable at the option of the person who acquires an interest in a managed investment scheme should be extended to include contracts involving those sales in section 707 which require disclosure.

Compliance

Qualifications and experience of compliance committee members

Recommendation 10

Standards should be developed relating to the qualifications and experience required by compliance committee members. This should be effected through consultation between ASIC and the industry, and draw on existing work of bodies such as the ICCMF and ACPA.

Appointment, removal and retirement of compliance committee members

Recommendation 11

ASIC, and members of a managed investment scheme, should be made aware of the identity of compliance committee members. To this end, REs should be required to inform ASIC and scheme members of the current composition of compliance committees, and when members of a compliance committee are appointed or removed, or when they retire.
Notification to ASIC should be based on existing requirements relating to company directors.

In the case of notifying members, it would be acceptable for the annual report to disclose any changes to the membership of the compliance committee that have occurred since the last report.

Recommendation 12

ASIC should have the power to remove a person from a compliance committee where ASIC forms the view that the person is not adequately performing the duties required of a compliance committee member, or where it is otherwise inappropriate for the person to continue to serve on the committee. The power should cover not only temporary suspension, but also permanent banning, subject to ASIC's decision being administratively reviewable.

The board of the responsible entity

Recommendation 13

The requirements in Chapter 5C covering the content of compliance plans in relation to the compliance committee, and the provisions setting out the functions of the compliance committee should be applied, with appropriate modifications, to the board of the RE, where there is no compliance committee appointed.

Incorporation of provisions by reference into compliance plans and constitutions

Recommendation 14

- Section 601HB, relating to the incorporation of provisions from one scheme compliance plan into another, should be amended to incorporate the changes currently provided for in ASIC Class Order 98/50.
- A provision allowing for the incorporation of provisions from one scheme constitution into another should be inserted into the legislation, along the lines of section 601HB (with the amendment suggested above).
- Incorporation-by-reference provisions should allow for incorporation of provisions from compliance plans and constitutions that do not relate to a particular scheme — that is, 'model' compliance plans and constitutions lodged with ASIC, subject to ensuring that REs continue to monitor the appropriateness and adequacy of compliance plans and constitutions on an individual scheme basis, and scheme members have adequate access to consolidated copies of compliance plans and constitutions.
- Subsection 601GC(4) should specify that members may request and receive a consolidated copy of a scheme's constitution from the RE, and a similar right should be given to members to request and receive a copy of a scheme's compliance plan.

Costs

Differential fees

Recommendation 15

- The requirement in paragraph 601FC(1)(d) that members holding interests of the same class be treated equally should be replaced with a requirement that such members be treated fairly, in respect of the charging of differential fees, subject to the requirement that investors are provided with adequate disclosure to allow them to compare the effect of differential fee arrangements.
- Further consideration should be given to whether there is also a need for the fairness 'test' to be interpreted by reference to some other criterion such as economic justification, and whether any interpretational material supporting the fairness test should be located in legislation or in ASIC policy.

Scheme registration — registering multiple trusts/schemes as a single scheme

Recommendation 16

Section 601ED relating to scheme registration should be amended to provide that where an applicant seeks to register more than one trust or scheme as a single scheme, ASIC may determine in writing that each trust or scheme must be registered separately.

- The explanatory memorandum accompanying this change should make clear that ASIC will exercise this discretion based on the degree of interdependence and economic relationship between the trusts or schemes;
- ASIC should issue policy guidance as to how it will exercise this discretion; and
- ASIC decisions should be subject to review by the Administrative Appeals Tribunal.

Other law reform proposals

Recommendation 17

The following amendments should be made to the Corporations Act and Regulations:

- Amend subsection 601JB(3) to insert 'and paragraph 4(a)' after '(2)(a)';
- Amend subsection 601JB(4) to insert 'or a related body corporate' after 'responsible entity';
- Extend section 601JE to apply to former compliance committee members;
- Amend section 205G to require disclosure by the directors of a RE of a listed scheme equivalent to disclosure required of directors of a listed company;
- Amend the definition of *managed investment scheme* to exclude class actions and costs paid for legal proceedings;
- Amend the definition of *scheme property* to clarify when property ceases to be scheme property;
- Amend section 115 so that it does not apply to registered managed investment schemes;
- Amend section 349 to impose a requirement that the value of scheme property be disclosed in the annual return, and to remove the requirement to identify the top 20 interest holders, and the total number of interests they hold, so far as it relates to members of IDPS-like schemes or, alternatively provide ASIC with discretion to determine an approved form for the annual return;
- Amend paragraph 601A(1)(a) to resolve the uncertainty regarding its ambit (namely, that it is wide enough to support ASIC's policy requirement for an independently verifiable price); and
- Incorporate regulations 5C.2.02, 5C.4.01, 5C.4.02, 5C.5.01 and 5C.11.06 (with certain modifications) into Chapter 5C, and repeal regulation 5C.11.05A.

Appendix 7: Parliamentary Joint Committee on Corporations and Financial Services Report on the Review of the Managed Investments Act 1998: Summary of recommendations

Chapter 4—The compliance committee

Recommendation 1

The Committee recommends that:

- the definition of 'external director' and 'external member' in sections 601JA and 601JB respectively of the *Corporations Act 2001* should be amended to ensure that:
  - they are independent;[256]
  - relatives and de facto spouses of ineligible individuals are ineligible to act on the compliance committee (whether as the board or an external compliance committee)[257]; and
- the meaning of 'material' be clarified.

Recommendation 2

The Committee recommends that the RE be required to:

- report all appointments, retirements, resignations or removals of compliance monitors (whether as members of the board or of a separate compliance committee) to ASIC within a specified period (e.g. 5 business days);
- disclose annually to scheme investors the names of all current compliance monitors; and
- disclose annually to scheme investors the names of compliance monitors who have retired, resigned or been removed in the previous year and the reasons for all resignations and removals.

Recommendation 3

The Committee recommends that ASIC be empowered to remove a member of a compliance committee where ASIC forms the view that the member is not performing adequately or otherwise should not be on the committee. The removal would be subject to reasonable notice requirements and rights to administrative review of ASIC's decision.

Recommendation 4

The Committee recommends that the *Corporations Act 2001* be amended to ensure that:

- the requirements in the compliance plan dealing with the arrangements which a compliance committee must make regarding membership, holding of meetings and so on, as far as appropriate, be expressly applied to the board when acting in the compliance monitoring role; and

---

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

257 The terminology used in the Act is 'relative or de facto spouse'. 'Relative' and 'de facto spouse' are defined in section 9 of the Act.

- the functions and duties applicable to the compliance committee, as far as appropriate, be expressly applied to the board when acting in the compliance monitoring role.

Recommendation 5

The Committee recommends that the *Corporations Act 2001* be amended so that the RE of a registered scheme must establish a compliance committee if a majority of its directors are not external directors.

Recommendation 6

The Committee recommends that the *Corporations Act 2001* be amended to allow a corporate compliance entity to act as a member of a registered scheme's compliance committee.

Recommendation 7

The Committee recommends that the *Corporations Act 2001* be amended to require:

- the compliance plan of a registered scheme to set out detailed minimum standards of competency and integrity which each compliance monitor must meet;
- any amendments to the compliance plan regarding these minimum standards must be approved by a majority of compliance monitors before lodgment of the amendments with ASIC. The copy lodged with ASIC should also be signed by the compliance monitors; and
- the RE to disclose details of the minimum standards annually, preferably at the same time as details of compliance monitors are disclosed.

Recommendation 8

The Committee recommends that ASIC, in consultation with industry, develop guidelines and model minimum standards for competency and—if considered necessary—integrity, for in-house compliance monitors.

Chapter 5—Compliance plan auditing

Recommendation 9

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

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

Recommendation 10

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

Recommendation 11

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

Recommendation 12

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

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

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

Chapter 6—Other checks and balances

Recommendation 13

The Committee recommends that ASIC review its NTA and insurance requirements for REs to determine whether they should be subject to periodic adjustment to take into account, for example, CPI rises or the quantum of funds under management.

Chapter 8—Costs and fees

Recommendation 14

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

- Australia's performance on costs and fees compared with major overseas financial centres;

- whether and to what extent the MIA has limited or stimulated competition within the industry; and
- whether understanding, transparency and disclosure for consumers has improved and/or is sufficient with regard to managed investments costs and fees.

Recommendation 15

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

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

Chapter 9—Proposals for change

Recommendation 16

The Committee recommends that the current provisions of the *Managed Investments Act 1998* relating to third-party custodianship, should be monitored by ASIC with regular reports being made to the Parliamentary Joint Committee on Corporations and Financial Services with particular regard to:

- the number of entities opting into third-party custodianship; and
- providing some qualitative comparative analysis of the performance of those entities with, and those without, third-party custodians.

The Committee further recommends that on the basis of these reports, the Committee should regularly review the efficacy of the current opt-in provisions in the Act compared with an alternative opt-out provision regarding optional third-party custodianship.

Select references and bibliography

1. Articles/Books/Reports/Media Releases

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