Investor protection

2.1 Introduction

When considering issues of investor protection in the managed investment industry, it is worth stressing that the MIA is not designed to safeguard investors against the risk that their investments might decline in value because of relatively poor investment strategies or downturns in the market more generally.

The ALRC/CASAC Report advanced the view that an appropriate level of investor protection in the managed investment industry could be achieved by focusing on, among other things, the minimisation of:

- institution risk — the risk that, in the event of the collapse of a scheme operator, the scheme's assets would not be adequately protected; and
- compliance risk — the risk that the scheme operator and its employees and agents would not adhere to legal requirements or would act fraudulently or dishonestly.

Draft legislation proposed in the ALRC/CASAC Report sought to address these risks, and formed the basis of the new organisational and regulatory structure for the managed investment industry introduced by the MIA.

A key driving principle behind the new framework was the shortcoming evident under the dual trustee/fund manager structure of the former regime, where it was difficult to determine who was ultimately responsible for a scheme's operation.

The proposals in this chapter relating to various aspects of investor protection do not readily lend themselves to categorisation beyond some broad subject areas. Nevertheless, to present these issues in as orderly a format as possible, they are grouped under some of the key elements of the MIA regime: the responsible entity (RE), the scheme, the scheme's constitution and scheme members.

2.2 The responsible entity — licensing

2.2.1 Net tangible asset (NTA) requirements

A RE must be a public company and hold a dealer's licence authorising it to operate a managed investment scheme.[1] ASIC is responsible for the assessment of applications and granting of licences[2] and has issued, among others, the following Policy Statements:

- PS 130 providing guidance on the licensing of REs to operate managed investment schemes; and
- PS 131 providing guidance on the financial requirements, including insurance arrangements, that a RE must satisfy to be eligible for a licence.[3]

To obtain a dealer's licence, an applicant must satisfy ASIC that, among other things, the value of its NTA is and will be maintained at a minimum of $50,000 or if the value of scheme property exceeds $10 million, an amount equal to 0.5 per cent of those assets up to a maximum of $5 million.[4] ASIC has a discretion under subsection 784(2B) to impose additional requirements in this regard. It is also able to impose conditions on licences.[5]

NTA requirements both in connection with the licensing of REs and ASIC's policy regarding the need for third-party custodians, attracted a range of comments.

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1 Section 601FA. When the changes made to the Corporations Act by the *Financial Services Reform Act 2001* (FSRA) come into force on 11 March 2002, section 601FA will be amended to require a RE to hold an Australian financial services licence rather than a dealer's licence.
2 Section 782.
3 Paragraphs PS 131.16 to 131.19 deal with insurance requirements. ASIC requires as a licence condition that REs maintain insurance cover against loss due to negligence or fraud by their officers. Standard policy requirements are not prescribed but a minimum cover is set at the lesser of $5 million or the value of scheme assets.
4 Subsection 784(2A). Under the changes to be made to the Corporations Act by the FSRA, an applicant not regulated by the Australian Prudential Regulation Authority and seeking an Australian financial services licence must satisfy the requirement in FSRA paragraph 912A(1)(d), that it will have 'available adequate' financial resources to conduct its operations. In this regard, ASIC issued for public consultation draft policy proposal, PS 166 *Licensing: Financial requirements*, on 16 November 2001. This followed a review of submissions received in response to ASIC's Policy Proposal Paper No. 10 on 21 September 2001.
5 Section 786. (See also subsection 914(1) which the FSRA will insert into the Corporations Act.)

According to one view,[6] the NTA requirements were sustainable for most operators, but for very large operations with multiple scheme operators, the requirements resulted in a high level of capital tied up to meet licence requirements.

Another submission[7] commented that there appeared to be no logical basis for the imposition of a $5 million NTA cap and a minimum $5 million professional indemnity insurance requirement. The submission argued that industry consultation would be needed on this issue as a necessary precursor to legislative reform or policy formulation. The concern was also expressed that NTA and insurance requirements imposed barriers to entry for small operators while entrenching the position of large-scale operators.

However, another submission,[8] argued that higher capital and insurance requirements than presently imposed should apply to REs. It contended that NTA, above a specified minimum amount, should be maintained at 1 per cent of funds under management without a cap, and that REs and directors should have professional indemnity insurance in proportion to funds under management. While the submission acknowledged that higher NTA levels would not protect against serious losses, it considered that additional preventative measures such as the imposition of NTA requirements on compliance entities and custodians would be desirable.

Part of the rationale underlying the legislative provisions and ASIC's policy regarding financial resource requirements is to ensure, as far as possible, that REs will have the financial stability to operate a scheme on a continuing basis. Among other things, the requirements take into account comparable regulatory regimes such as that under the *Superannuation Industry (Supervision) Act 1993* (SIS Act).[9] The requirements are intended to provide 'some protection for members against loss because of negligent administration or fraud by officers or agents'[10] but it would be unrealistic for investors to expect a full recovery of their losses in all cases from a RE's NTA in the event of a collapse.

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6 Ernst & Young.
7 Trust Company of Australia Limited.
8 Trustee Corporations Association of Australia.
9 See ASIC policy statement (PS 131) in which ASIC also refers to financial requirements in the law, the diversity of schemes and the need for investor protection as influencing its formulation of policy for financial requirements.
10 See ASIC PS 131, paragraph 131.10.

ASIC's submission (part two) suggested that, if the NTA requirements for Approved Trustees under the SIS Act were considered by the Superannuation Working Group[11] to need revision, it might be appropriate to consider whether the requirements for REs should be similarly revised.

This issue is a complex one and raises many questions relating to the underlying objective of NTA requirements and whether relatively small increases to the existing requirements would result in any practical change in investor protection. Indeed, in the context of the selection of an appropriate capital requirement, the ALRC/CASAC Report referred to the 'widespread acknowledgment that any amount chosen will be arbitrary and, for some schemes, inappropriate'.[12]

If a persuasive case were made for higher NTA requirements, this would still need to be considered against the costs of imposing higher requirements across the entire industry.

While the regulatory objectives and principles applicable to the managed investment and superannuation industries may differ, there are sufficient parallels between these industries to justify reconsideration of NTA requirements in light of any findings that may flow from the Superannuation Working Group.

2.2.2 Appointment of third-party custodians

One of the duties of a RE is to hold scheme property on trust for scheme members.[13] However, ASIC may require that scheme property be held by an agent.[14]

ASIC's policy requirement for REs to appoint third-party custodians in certain circumstances, attracted comments that:

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11 A Superannuation Working Group has been set up to consider an issues paper on the prudential regulation and governance of superannuation funds. Five key options will be considered, among them, minimum capital for all funds. Comments on the issues paper are to be made by 1 February 2002.

12 See paragraph 10.27 of the report.

13 Subsection 601FC(2).

14 Under subsection 784(2B), ASIC may require an applicant for a dealer's licence to appoint a third-party custodian. Under subsection 601QA(1), 'ASIC may declare that (Chapter 5C) applies to a person as if section 601HA included a requirement for scheme property to be held by a person other than the responsible entity as the responsible entity's agent.'

- the operational structure, compliance and reporting mechanisms already required by the MIA were providing sufficient investor protection, and ASIC's requirement for an independent custodian merely increased the administrative burden and costs for a RE;[15]

- self-custody should be permitted where NTA requirements had been met;[16]

- the existence of a separate custodian should be dispensed with because of the difficulties involved in determining issues of accountability where the custodian was more than a bare trustee;[17]

- the split in legal and beneficial ownership between the custodian and the RE caused problems when scheme property was leased or mortgaged. This added to the administrative complexities of these types of arrangements and increased costs without providing any additional protection.[18] In the context of ASIC's Policy Statement (PS 133),[19] the view was advanced that to require property managers who collected rentals generated by scheme property to meet the requirements for custodians set out in the Policy Statement was inconsistent with commercial realities;[20]

- in the interests of investor protection, scheme property should be held by an independent custodian in all instances. The mandatory use of independent custodians would be more effective in preventing fraud or self-dealing by the RE than the present arrangements, which allow for self-custody or custody by a party related to the RE. Custodians should be licensed by ASIC and should owe limited duties to scheme members;[21]

- there should be compulsory use of external, unrelated custodians for all schemes except where ASIC considered that self-custody would not

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15 Confidential submission.
16 Minter Ellison.
17 Freehills.
18 Freehills.
19 PS 133 is entitled: *Managed investments: Scheme property arrangements* and provides guidance on several matters including the standards required of scheme property custodians.
20 ASIC's draft policy proposal, PS 166 (see footnote 4) proposes NTA requirements for custodians.
21 Trustee Corporations Association of Australia. The duties of the custodian proposed in this submission would be to identify and hold assets separately, to refer to the compliance entity cases of suspected self-dealing, and to reject instructions if there was knowledge of fraud. See further discussion in point 2.2.3.

threaten investor protection. If independent custodians were required, their NTA and insurance could be taken into account when assessing NTA requirements for REs;[22] and

- any amendment to introduce an optional trustee/manager structure would be undesirable. It would not enhance investor protection but merely create uncertainty about accountability to investors.[23]

While arguments favouring the appointment of mandatory third-party custodians may carry some merit, such a requirement would not sit easily with the rationale for replacing the dual trustee/fund manager structure with a single RE. This is particularly so as the introduction of mandatory third-party custodians could potentially compromise and confuse the special position of the RE with respect to scheme members.

Furthermore, the discretion conferred on ASIC to issue licences conditional on the appointment of third-party custodians provides a degree of flexibility which is desirable in a large and dynamic industry.

At this early stage of the legislation's operation and without convincing arguments for change, it is thought that the status quo should be retained.

2.2.3 Liability of third-party custodians to scheme members

Several submissions raised the question of the accountability of a third-party custodian to scheme members for losses caused by the custodian's acts or omissions, or those of the RE.

The MIA clearly imposes liability on the RE for acts or omissions of its agents even where they have acted fraudulently or outside the scope of their authority or engagement.[24] Section 601MA provides that a member of a registered scheme who has suffered loss or damage because of the conduct of

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22 Trust Company of Australia Limited.
23 Commonwealth Bank Group.
24 Under subsection 601FB(2), the RE may appoint an agent to carry out its functions but in determining whether there is liability to the scheme members or whether the RE has properly performed its duties, the RE will be taken to have done, or failed to do, anything that the agent has done, or failed to do, even if the agent was acting fraudulently or outside the scope of its authority. The conduct of an agent is therefore taken to be the conduct of the RE.

the RE that contravenes Chapter 5C may take proceedings against the RE to recover the loss or damage.[25]

The MIA regime does not expressly facilitate accountability to scheme members for loss or damage suffered as a result of contraventions of Chapter 5C by parties other than the RE. However, it is possible under section 1325 for a person who has suffered loss or damage as a result of a contravention of Chapter 5C, to bring proceedings against any person responsible for the contravention or involved in the contravention. Section 1324 enables a person whose interests have been, are or would be affected by a contravention of the Corporations Act to seek an injunction under similar circumstances.

There was no consensus in the submissions about what a custodian's responsibilities and obligations might be to scheme members, particularly where a custodian carried out a RE's instructions which it knew to be unlawful. As one submission[26] indicated, the liability question was compounded by the fact that there were no standard terms of appointment for custodians and these consequently varied from scheme to scheme.

In two submissions,[27] a legislative amendment was proposed to provide that:

- a custodian would not be liable to investors when acting on the RE's instructions; and
- this was regardless of whether or not the custodian was actually aware of the contents of the scheme's constitution, compliance plan or offer documents.

In addition, the view was taken that the custodian should not be required to inform itself of the contents of the various scheme documents in any case. A further argument was advanced[28] that a RE should not be liable for the actions of a defaulting agent (such as a custodian) if it could be shown that the RE took

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25 A member might suffer loss or damage because the RE has failed to comply with its duties set out in section 601FC. For example, it may have misappropriated scheme property or failed to make distributions in accordance with the fair and equal treatment principles applying to members.
26 Minter Ellison.
27 IFSA and Minter Ellison.
28 IFSA.

reasonable care and diligence in the selection of the agent, and monitored its performance.

In contrast to this, another submission[29] proposed a liability regime under which, among other things, the third-party custodian would be required to refer cases of suspected self-dealing to the relevant compliance entity and to reject the relevant RE's instructions if it had knowledge of fraud. The compliance entity, in turn, would have the responsibility of pursuing remedies against the RE, directors and agents where there was evidence of fraud, negligence or maladministration.

In considering these submissions, it is worth revisiting one of the key recommendations of the ALRC/CASAC Report. This report recommended that the dual trustee/fund manager structure of the prescribed interest regime should be replaced with a single RE directly responsible to scheme members in its operation of the scheme. The intention was to avoid the confusion over accountability fostered by the dual trustee/fund manager structure of the previous regime. The Explanatory Memorandum for section 601MA clearly reflects an intention consistent with these objectives. It indicates that the reason for not extending the application of section 601MA to actions against persons other than the RE was to 'preserve the concept of a single responsible entity responsible to members for the operation of a scheme'.[30]

In making the RE responsible for its agents, whether or not they have acted within the scope of their authority or engagement, the MIA sought to avoid the displacement of responsibility from the RE and thus confusion over liability.

As far as agents such as third-party custodians are concerned, the MIA does not expressly make them accountable to scheme members, nor does it charge them with any duties or responsibilities. However, the current provisions do not preclude the liability of parties other than the RE to scheme members.

It is considered that any attempt to define the accountability of third-party custodians or to impose duties and obligations upon them should be approached with the utmost caution. Furthermore, the legislation is still in its early stages and, not unexpectedly, there appears to be no instructive case law on the subject. If legislative intervention were proposed, great care would

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29 Trustee Corporations Association of Australia.
30 Refer to paragraphs 14.1 and 14.2.

have to be exercised to ensure that it did not create the same sort of confusion over accountability that was one of the more significant failings of the former regime.

In view of this, legislative prescription of a custodian's duties and liability is not considered to be desirable.

2.3 Changing the responsible entity

2.3.1 Members' rights to remove and replace the responsible entity

Members are entitled to vote on resolutions to:

- remove a RE; and
- replace a removed or retiring RE.[31]

Members are also entitled to apply to the Court for the appointment of a temporary RE where a scheme does not have a RE that meets the requirements of the MIA.[32]

Subsection 601FM(1) enables members of a registered scheme to remove the RE by taking action under Division 1 of Part 2G.4 to call a members' meeting to consider voting on a resolution to remove the RE and elect a replacement.

Section 252B of Division 1 of Part 2G.4 provides for the RE's calling of a members' meeting on the request of members to vote on 'a proposed special or extraordinary resolution'.[33]

There is a specific reference in subsection 601FM(1) to the requirement for an extraordinary resolution to remove or appoint a RE of an unlisted scheme.

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31 Subsection 601FL(1) provides for members to vote on a new RE to replace a retiring RE and section 601FM provides for members to vote on the removal and replacement of a RE.

32 Section 601FN.

33 An extraordinary resolution has to be passed by at least 50 per cent of the total votes that may be cast by members who have an entitlement to vote. All members' votes are taken into account whether or not present in person or voting by proxy. A special resolution must be passed by at least 75 per cent of the votes of the members present (either in person or by proxy) and voting.

However, there is some uncertainty whether a special or ordinary[34] resolution is needed to remove or appoint the RE of a listed scheme.

It would appear from subsection 601FM(1) and section 252B that a special resolution would apply to listed schemes but this does not appear to have been Parliament's intention.

The provisions in Part 2G.4 were introduced by the *Corporate Law Economic Reform Program Act 1999*. It appears from the Explanatory Memorandum for this legislation that the removal or appointment of a RE of a listed scheme was to be by ordinary resolution.[35] Subsection 252L(1A) supports this argument regarding Parliament's intention. It provides that a resolution, notice of which has been given to the RE by members, must be a special resolution, an extraordinary resolution, or '*a resolution to remove the responsible entity of a scheme that is listed and choose a new responsible entity*'. (emphasis added).

Two issues have arisen in the context of these provisions.

One concerns the question of whether legislative amendment is necessary to ensure that subsection 601FM(1) does not qualify the operation of subsection 601FJ(2) by allowing extraneous provisions (such as those contained in a scheme's constitution) to govern the requirements for removal of a RE.[36]

The second question concerns whether it would be appropriate to vary the voting threshold for the removal of a RE by members, and the appointment of a new RE for listed and unlisted schemes.

In relation to the first question, ASIC has expressed the view that subsection 601FJ(2) should be amended to ensure that the application of the procedures of Division 2 of Part 5C.2 are an exclusive code governing the removal of a RE.

ASIC's proposal appears to have been prompted by the decision in *MTM Funds Management Ltd v Cavalane Holdings Pty Ltd*[37] in which the RE of a listed

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34 'Ordinary resolution' is not defined in the Corporations Act. However, an ordinary resolution is generally understood to be one which requires at least 50 per cent of the votes of the members present (either in person or by proxy) cast at a meeting.

35 See paragraphs 7.9 to 7.11.

36 Subsection 601FJ(2) provides that a purported change in a scheme's RE is ineffective unless it is in accordance with Division 2 of Part 5C.2.

37 (2000) 18 ACLC 819.

scheme sought advice from the New South Wales Supreme Court on whether a resolution for its removal at a requisitioned meeting had to be special, as provided in subsection 252B(1) (in Division 1 of Part 2G.4), or ordinary, as provided by the scheme's constitution.

In this case, the Court reasoned that, unless the relevant constitutional provision was in conflict with and therefore not in accordance with a provision of Division 2 of Part 5C.2, it should be allowed to operate. Because the scheme was listed, no conflict arose and it was consequently within the members' powers to remove the RE by ordinary resolution. The situation would have been different had the scheme been unlisted because section 601FM expressly provides that extraordinary resolutions are required to remove and replace the RE of an unlisted scheme.

It is considered undesirable that voting provisions in a scheme's constitution should override legislative requirements. The RE is intended by the legislation to play a pivotal role in the operation of the scheme. If constitutional provisions were to set too high or too low a voting threshold for the removal of a RE, the interests of investors could be severely compromised.[38]

Given the view expressed earlier that the Parliament's intention appears to be that resolutions to remove or appoint the RE of a listed scheme should be ordinary resolutions, the effect of the decision in the MTM Funds Management case actually achieved the aim of the legislation, as the scheme constitution in that case required an ordinary resolution. However, other circumstances may arise where the scheme constitution sets an inappropriate threshold for resolutions to remove or appoint a RE of a listed scheme. The principle remains that constitutional provisions should not be capable of overriding or varying voting thresholds set down in the legislation.

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.

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38 In part two of its submission, ASIC has suggested that the decision in *MTM Funds Management Ltd v Cavalane Holdings Pty Ltd* opens the way for constitutional provisions to automatically remove a replacement RE and so entrench the original RE.

In relation to the second question (that is, whether voting thresholds for RE appointment or removal should be varied), a number of submissions[39] proposed that members should be able to replace a retiring RE of an unlisted scheme by a special instead of an extraordinary resolution. The view was expressed that, for most funds, it was almost impossible to pass an extraordinary resolution.[40]

In a similar vein, it was argued that high voting thresholds for unlisted schemes and the fact that the RE was charged with arranging the necessary member meeting, had enabled REs to entrench their positions.[41]

Although no submissions specifically referred to the resolutions required for the removal and replacement of a RE of an unlisted scheme under section 601FM (as opposed to the replacement of a retiring RE under section 601FL), it would seem desirable to align the voting thresholds in both situations. There seems to be no obvious reason why different voting thresholds should apply to the appointment of a new RE depending on whether the former RE retired or was removed. Likewise, in the absence of compelling evidence to the contrary, the voting threshold for the removal of the RE should be the same as the threshold applying to the vote on a replacement.

The power to remove an underperforming RE through a vote (and to appoint a replacement) is an important right for scheme members, and voting thresholds should not be so high as to effectively entrench a RE.

By the same token, if a scheme is to have stability and continuity, it is important that the RE has an appropriate degree of security of tenure, and is not liable to be removed at the behest of a group of scheme members whose views may not be representative of the members generally.

Taking these competing objectives into account, it is felt that the current requirement for an extraordinary resolution for the removal and replacement of the RE of an unlisted scheme is, on balance, too restrictive. It is therefore recommended that the threshold be reduced.

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39 IFSA, Minter Ellison and the Law Council of Australia.
40 IFSA and Minter Ellison.
41 Trust Company of Australia Limited.

One option would be to move to a special resolution as suggested in submissions (although the suggestions were limited to instances of appointment following retirement). Alternatively, the special resolution could be retained but with an additional threshold, such as existed under the previous prescribed interest regime. This 'hybrid' threshold involves requiring a special resolution as well as votes representing 25 per cent of the total value of interests in the scheme.[42] In essence, therefore, the resolution would have to be supported by 75 per cent of the votes cast by members at the meeting, and these votes would have to represent at least 25 per cent of the total votes of all scheme members.

In the case of listed schemes, as alluded to above, it is accepted that the intention of Parliament was that removal and appointment of a RE should require an ordinary resolution only. While there may be arguments that the same thresholds should apply regardless of whether a scheme is listed or not, they have not been made in submissions and it seems reasonable that differentiation continues.

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.

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42 Former paragraphs 1069A(2)(c) (relating to voting on the modification of an approved deed) and 1076T(2)(c) (relating to voting on a special variation proposal in related to a trust deed) had these 'hybrid' thresholds.

2.3.2 Alternative qualifications for temporary responsible entities

Under section 601FN, ASIC or a member of a registered scheme may apply to the Court for the appointment of a temporary RE if the scheme does not have a RE that meets the requirements of section 601FA.[43]

Concerns were raised[44] that it was sometimes difficult to find an entity appropriately qualified and capable of assuming the role of a temporary RE.[45]

To assist in overcoming this problem, suggestions were made that the categories of entities which could take over the operation of schemes on a temporary basis should be expanded to include an official liquidator.[46]

This would widen the pool of suitable candidates and go some way towards lessening delays in the appointment of temporary REs.

However, it is recognised that it will not necessarily deal with all issues connected with the replacement of a RE. For example, the 'inheritance' of contracts entered into by the former RE, has tended to deter otherwise suitable candidates from taking on the role of a temporary or new RE.[47]

Notwithstanding this, it is agreed that an official liquidator should be able to assume the role of a temporary RE.

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.

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43 These are that the RE must be a public company and hold a dealer's licence that authorises it to operate a managed investment scheme.

44 ASIC — part two, Law Council of Australia.

45 In part two of its submission, ASIC has commented that, in practice, this would be an existing RE authorised to operate a scheme.

46 ASIC — part two: ('official liquidator'), Law Council of Australia ('registered insolvency practitioner'). Under subsection 1283(1) ASIC may register as an official liquidator a natural person who is a registered liquidator. The requirements for registration as a liquidator are set out in section 1282.

47 This particular issue is discussed in Chapter 4.

2.3.3 Protection of scheme property

ASIC has the power to revoke the licence of a RE that is not performing its duties[48] and to apply to the Court for the appointment of a temporary RE.[49]

In its submission, ASIC expressed concern that any delay in securing the Court appointment of a temporary RE could prejudice the safety of scheme property. It proposed that to overcome this problem, it should be given administrative powers either to appoint a temporary RE (similar to the power the Australian Prudential Regulation Authority has under section 134 of the SIS Act) or to make binding orders for the protection of scheme property.

The protection of scheme property is considered of paramount importance to investor protection. It is accepted that delays associated with the need for a Court appointment of a temporary RE or the shortage of suitably qualified and willing candidates to take on the role, could pose a real risk to the safety of scheme property. For this reason, it is considered that legislative amendment along the lines of ASIC's second option is warranted. The second option would allow for more timely arrangements concerning scheme property and the intention would be for ASIC's orders to operate only until such time as a temporary RE was in place.

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.

2.4 The scheme — registration requirements

Subsection 601ED(1) provides that a managed investment scheme must be registered if it has more than 20 members; was promoted by a person in the

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48 Under section 825A, ASIC may revoke a licence held by the RE of a registered scheme if it is satisfied that the members have suffered or are likely to suffer loss or damage because of a contravention of the Act by the RE. Under changes to the Corporations Act to be made by Part 7.6, Division 4 of the FSRA, ASIC will have powers to vary, suspend or cancel a RE's licence.

49 Section 601FN.

business of promoting managed investment schemes; or is subject to a determination by ASIC that it is a managed investment scheme.

However, this subsection operates subject to subsection 601ED(2) which links the requirement for registration to disclosure requirements under Part 6D.2 of the Corporations Act.[50]

Generally under Part 6D.2, disclosure to investors is needed when the investor is likely to be a retail investor as opposed to a 'sophisticated' or a 'professional' investor.[51]

In its submission, ASIC commented on the following difficulties in interpretation arising from subsections 601ED(1) and (2):

- subsection 601ED(1) provides, among other things, that subject to 601ED(2), registration is required if a scheme has more than 20 members. However, subsection 601ED(2) conflicts with subsection 601ED(1). This is because the application of section 708 in Part 6D.2 has the effect that subsection 601ED(2) does not require a managed investment scheme to be registered unless the number of people to whom it issues interests exceeds 20 in any 12-month period. (This assumes also that the $2 million ceiling in any 12-month period has not been exceeded.) Under subsection 601ED(2), therefore, a scheme might have over 20 members but not have to be registered because fewer than 20 members acquired their interest in any 12-month period. Subsection 601ED(1) would require registration of such a scheme because its 20 plus member limit is not set within any timeframe;

- subsection 601ED(2) refers only to issues, and not sales, of interests. Part 6D.2 deals with sales as well as issues. This raises uncertainty about whether sales were intended to be included; and

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50 Subsection 601ED(2) provides that 'a managed investment scheme does not have to be registered if all the issues of interests in the scheme that have been made would not have needed disclosure to investors under Part 6D.2 (see sections 706 and 708) if the scheme had been registered when the issues were made.' Under the changes to the *Corporations Act* to be made by the FSRA, the reference in subsection 601ED(2) to Part 6D.2 will be replaced by a reference to Division 2 of Part 7.9 which will impose similar disclosure requirements. Section 1012E, to be inserted into the Corporations Act by the FSRA, will apply to managed investment schemes instead of the current sections 706 and 708.

51 See subsections 708(8) and 708(11) of the Corporations Act. There are a number of other exceptions but the general thrust of the provisions is to protect the retail investor.

- section 601ED appears to provide no mechanism to take into account sales of managed investment scheme interests made to retail investors through custodial arrangements. (The same questions are raised by the provisions in Division 2 of Part 7.9 which will be inserted into the Corporations Act by the FSRA.)

ASIC has suggested that subsection 601ED(2) be amended to:

- remove the reference to Part 6D.2;
- apply to sales or issues to retail clients by the RE or a person associated with the RE; and
- apply to an acquirer in relation to a custodial arrangement who acquired the interest pursuant to an instruction from a retail client.

ASIC also proposed amendments to section 1012C (to be inserted into the Corporations Act by the FSRA).[52]

Section 1012C applies a rebuttable presumption of intention in relation to sales and off-market sales by controllers of financial products[53] that amount to indirect issues.[54] The presumption has the effect that the person issuing and the person acquiring the financial product upon its original issue are taken to have issued or acquired the financial product with the purpose that it would be on-sold. The presumption only applies to sales made within 12 months of issue. ASIC has commented that, with time sharing schemes, it is apparently common for all the interests in a scheme to be issued first to a developer who then sells them over a period of several years. The 12-month time limit applying to the rebuttable presumption in the provisions is consequently of only limited application to time sharing schemes.

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52 Currently section 707. Section 1012C requires the giving of a Product Disclosure Statement (PDS) to a retail purchaser in certain circumstances when a financial product is offered for sale or when a person offers to acquire a product by way of transfer.

53 A financial product in this provision can be an interest in a managed investment scheme.

54 Subsection 1012C(6) applies to sales within 12 months after issue that amount to indirect issues. Subsection 1012C(8) applies to off-market sales within 12 months of sale by controllers that amount to an indirect issue. A *controller* is a person who controlled the issuer of the financial product at time of sale. Section 50AA of the Corporations Act defines *control.* Briefly, an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity's financial and operating policies. The rebuttable presumption for subsection 1012C(6) is set up in subsection 1012C(7) and for subsection 1012C(8), in subsection 1012C(9).

It is considered that section 601ED should be amended to overcome the problems regarding its interpretation and coverage. However, the implications of amending section 601ED and the other changes proposed by ASIC, need to be fully explored to ensure that there will be no unexpected and undesirable consequences. It is suggested that these issues be subject to further consultation involving the Treasury, ASIC, the industry and the investing public to ascertain the best approach for implementing any changes.

2.5 The scheme's constitution

Section 601GA provides that a scheme's constitution must make adequate provision for a limited number of matters. No other constraints are imposed on the content of a scheme's constitution except, of course, that it must be consistent with other statutory requirements and the law.

Section 601GB provides that the constitution of a registered scheme must be contained in a document that is legally enforceable between members and the responsible entity.

ASIC raised two concerns in connection with these provisions.

The first concern was with constitutions containing provisions contrary to law which ASIC has discovered in the course of its surveillance activities. ASIC argued that its exemption and modification power under section 601QA was not sufficiently wide to enable it to direct or effect changes to constitutions.

It proposed that the legislation should be amended to enable it to make amendments or additions to constitutions so that they would comply with statutory requirements. If such a power was conferred on ASIC, decisions made pursuant to the exercise of this power would be reviewable by the Administrative Appeals Tribunal under Part 9.4A of the Corporations Act.

ASIC's second concern related to the enforceability of scheme constitutions. ASIC is aware of some constitutions which do not appear to be legally binding. Some of these were constitutions 'converted' from trust documents during the transitional period for the new legislation.

It is difficult to formulate a practical and reliable way of identifying and correcting these anomalies concerning what might be a substantial number of scheme constitutions, other than through legislative amendment.

Given this, it is considered that legislative amendments to make scheme constitutions legally binding and enforceable by virtue of the MIA and to provide ASIC with limited powers to alter constitutions, are necessary to guard against an erosion of investors' rights and the efficacy of schemes generally.

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.

Subsection 601GA(2) has also attracted comment. The subsection provides that if a RE is to have rights to be paid fees out of scheme property or to be indemnified out of scheme property for liabilities or expenses incurred in relation to the performance of its duties, the scheme constitution must specify those rights and require that they apply only in relation to the proper performance of those duties. This provision cannot be contracted out of.

One submission[55] argued that the provision was ambiguous and could be interpreted to mean that a RE would not be entitled to recover fees at all where it had breached one of its duties and could not remedy this breach by a payment of money.

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55 IFSA.

ASIC made a number of comments in relation to this provision and to Part 5C.3 generally.

ASIC was concerned that subsection 601GA(2) was ambiguous and failed to protect scheme members against questionable fee payment practices that had come to ASIC's attention. Modifications to the legislation were suggested that would:

- impose a prohibition on all provisions, whether or not in a scheme's constitution, that provided for a fee or right of indemnity where the timing of payment or the entitlement to the indemnity related to a change in the RE. Such 'poison pill' provisions can operate to entrench a RE;[56]
- clarify that the words, 'in relation to the performance of its duties' (where they first occur) relate both to 'rights to be paid fees out of scheme property' and to 'be indemnified out of scheme property for liabilities or expenses incurred';
- clarify that a RE may not receive fees or indemnities out of scheme property in advance of the proper performance of its duties;[57]
- provide that, where a RE is required by subsection 601GA(2) to provide details in the scheme constitution in relation to rights the RE may have to be paid fees or to be indemnified out of scheme property, it also provides details where these rights relate to fees or indemnities to be paid out of any other source;[58] and
- exclude any person other than the RE from having any right in respect of scheme property or against members (such as the payment of fees or the entitlement to an indemnity) for services provided in connection with the

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56 In part two of its submission, ASIC has indicated that the constitutions of some schemes it examined, enabled a RE to claim large fees as a result of its removal or retirement.

57 In part two of its submission, ASIC has advised of a practice where some REs are drawing fees or claiming indemnities in relation to the performance of their duties prior to their actual completion or commencement. In some cases, the RE has gone into liquidation before the intended activity of the scheme has commenced.

58 A RE would consequently have to account to members for fees or indemnities drawn from payments made by investors directly to the RE where, for some reason, these payments did not become scheme property.

- operation of the scheme.[59] Subsection 601GA(2) is drafted in such a way that it might be possible to argue that payments made to agents before property is remitted to the RE are not payments made out of scheme property.

The protection of scheme property is obviously an important aspect of the legislation. For this reason, the proposed legislative amendments, with one exception (see below), are considered necessary to resolve ambiguity and close off avoidance practices that have arisen in relation to the payment of fees and the claiming of indemnities.

The exception relates to ASIC's suggestion that a scheme constitution should be required to detail the rights of the RE to be paid fees or to claim an indemnity not only in relation to scheme property but also in relation to other sources not classified as scheme property. It is considered that further investigation and possibly industry consultation is necessary before an amendment in this regard should be made.

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

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59 In part two of its submission, ASIC has argued that, in some cases, agents are claiming fees and indemnities in relation to work performed directly from scheme property. One area where this occurs is in time sharing schemes where payment might be made directly to a developer which then remits a net amount to a RE.

- 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.

2.6 Scheme members

2.6.1 Annual General Meetings (AGMs)

Some submissions supported the introduction of mandatory AGMs for managed investment schemes.[60]

An opposing view[61] cited the high costs of such meetings, the anticipated lack of investor interest[62] and the perceived inappropriateness of investors commenting on investment decisions given the structure of and rationale for managed investment schemes. However, support was expressed for a requirement for annual reports to inform members of their rights to requisition a meeting.

On this point, it appears that there is no specific provision in the Corporations Act under which scheme members can requisition a general meeting without having to propose a resolution to be passed at the meeting.

Section 252L enables members[63] to requisition a meeting through the RE to vote on a resolution. Again, under sections 252B and 252D, it appears that members[64] cannot requisition a meeting unless a special or extraordinary resolution is to be proposed and voted on at the meeting. Whereas section 252B provides for the RE's requisitioning of a meeting on the request of the specified number of members, section 252D enables the members to requisition a meeting themselves. However, under section 252D, the members

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60 CPA Australia and The Institute of Chartered Accountants in Australia (joint submission), MAI Services Pty Limited and Australian Stock Exchange Limited.

61 IFSA.

62 IFSA bases this on the experience of many of its members during the transition period when they were required to hold unit holder meetings.

63 These members must have at least 5 per cent of the votes that may be cast on the proposed resolution. Alternatively, at least 100 members entitled to vote at the meeting can requisition the meeting.

64 Sections 252D and 252B require members having at least 5 per cent of the votes that may be cast at a meeting. Section 252B provides an alternative of at least 100 members who are entitled to vote on the resolution.

calling the meeting must pay the expenses of calling and holding the meeting which would probably be a deterrent to the widespread use of this provision.

On the other hand, the members of a company can requisition a general meeting through the company directors in certain circumstances[65] under section 249D. This provision does not apply to managed investment schemes.

AGMs would certainly provide a useful opportunity for member scrutiny of a RE's activities. They would also be in keeping with the accountability of REs to scheme members. However, drawing on the experiences of schemes during the transition period and bearing in mind the substantial expense involved in holding AGMs, attendance levels might not be sufficient to justify a mandatory requirement.

In the ALRC/CASAC Report, reference is made to ALRC Discussion Paper 53 which, among other things, proposed that the operator of a collective investment scheme should be required to hold an investors' meeting annually.[66] The Report comments that the proposal met with overwhelming opposition.[67] The main reasons given were that the expenses involved in calling general meetings would outweigh the benefits; managed investment schemes did not have the same need for AGMs as did companies[68]; annual reports would be less costly than, and as effective as general meetings were for disseminating information, and investors under the current law could call meetings if they considered it desirable or necessary.

On the basis of these submissions, the Report concluded that operators should not be required to call AGMs.

It is worth noting that there is presently no legislative requirement for superannuation funds to hold AGMs. This is one of the issues that the Superannuation Working Group will be considering.

It is considered that it may be worth revisiting this proposal when the findings of the Superannuation Working Group are known.

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65 The directors of a company must call and hold a general meeting at the request of members with at least 5 per cent of the votes that could be cast at the meeting. Alternatively, the request must be made by at least 100 members who are entitled to vote at the meeting.

66 ALRC DP 53, 1992 — Proposal 7.3.

67 ALRC/CASAC Report, paragraph 11.24.

68 Companies needed AGMs to elect directors, present accounts and declare dividends.

In the meantime, it is considered that the legislation should be amended to enable scheme members to call general meetings without the need to put a special or extraordinary resolution before the meeting. This would at least simplify the process for members.

It is also considered that REs should be obliged to place prominent notices in their annual reports advising members of their rights to requisition 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.

A related issue is whether the MIA should be amended to require the provision of additional information to investors. (Such information, for example, could include the taxation implications of investing in managed investment schemes and schemes' investment strategies.)[69] There is also the question of whether the content and format for presentation of information to investors should be standardised to enable ease of comparison.[70]

Under changes to the Corporations Act to be made by the FSRA, investors must be supplied with a Product Disclosure Statement in relation to their proposed investment in a managed investment scheme. These statements are to contain information that a person would reasonably require, as a retail client, before deciding whether to acquire an interest in a scheme. Such information is specified in the legislation and includes information about product costs, ongoing payments that might be required, deductible fees, expenses or charges, commissions that may impact on returns, and significant taxation implications.[71]

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69 Submission from D J Munro AM.

70 Submission from R D Filmer proposed the standardisation of tax statement summaries. Submission from Eng Seng Toh proposed that disclosure of management fees should be standardised for purposes of comparison.

71 See Division 2 of Part 7.9 for the changes to be introduced into the Corporations Act by the FSRA.

In addition, information concerning the performance of a fund must be given to members on an ongoing basis covering yearly intervals or lesser periods. These 'periodic statements' must include information that will help members assess the performance of their funds and advise them of the nature and purpose of transactions during the disclosure period.[72]

The legislation does not specifically require the provision of information on investment strategies although the constitution of a registered scheme must make adequate provision for the powers of the RE in relation to investments of, or otherwise dealing with scheme property.[73]

In contrast to this, the trustee of a superannuation fund must give to each fund member, among other things, a description of the fund's investment strategy at periodic intervals, generally, of 1 year.[74] The strategy should take into account risks, likely returns, the composition and diversity of the entity's investments as a whole, the liquidity of the investments and the ability of the entity to discharge its liabilities.[75]

Clear and concise information for investors is crucial to enable them to make informed investment decisions. The changes to the Corporations Act to be made by the FSRA should go a long way towards satisfying investors' information needs. It is therefore considered that issues relating to content and standardisation of investor information would be more appropriately assessed after the FSRA disclosure provisions have been in place for some time and the effect of industry efforts and ASIC guidance can be gauged.

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72 Section 1017D to be inserted into the Corporations Act by the FSRA, requires periodic statements to include details of: opening and closing balances; the termination value of an investment as at the end of the interval covered; a transaction summary with details of the nature and purpose of a transaction; and increases in contributions and returns on investments.

73 Paragraph 601GA(1)(b).

74 Regulation 2.28 of the Superannuation Industry (Supervision) Regulations 1994. Division 2.4 of Part 2 of these regulations sets out the 'reporting periods' that apply to the provision of information to fund members.

75 Paragraph 52(2)(f) of the SIS Act.

2.6.2 Liability of scheme members

It is possible that, depending on a fund's constitution, the liability of scheme members in the event of a fund's winding up might be unlimited.[76]

During the Senate debate on the Managed Investments Bill, the Australian Democrats proposed that a limitation be placed on a member's liability on the winding up of a scheme to the member's notional share or interest in the scheme. This proposed limitation was intended to parallel shareholders' liability on the winding up of a company limited by shares.

Following the passage of the Bill, the then Minister for Financial Services and Regulation asked CASAC to advise on the liability of members of managed investment schemes. CASAC considered this issue in its *Report to the Minister for Financial Services and Regulation on Liability of Members of Managed Investment Schemes*, dated March 2000.

CASAC's conclusions were that the rationales for extending limited liability to shareholders of companies applied equally to members of managed investment schemes.[77] Its favoured option was to amend the Corporations Act (then the Corporations Law) to provide for a limitation on the liability of members of all registered schemes and for ASIC-exempt schemes in the same manner as shareholders of a company limited by shares. An exception was proposed where the inherent nature of a scheme or scheme provisions imposed liability on scheme members beyond their initial contribution.[78]

ASIC has commented that it may be worthwhile to investigate the liability of members in circumstances other than a scheme's winding up. It also believes that pertinent and complex questions would be likely to arise in the implementation of CASAC's recommendations. One such question concerns the bases on which it would be appropriate to exempt some schemes from a limitation on members' liability.

The issues concerning members' liability are significant. It is proposed that the CASAC study should be used to assist with the development of propositions

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76 See, for example, submissions from D Routley and the Australian Stock Exchange Limited.
77 See page 4 of CASAC's report.
78 See recommendations on pages 10 — 11 of CASAC's report.

for limitation of members' liability in consultation involving Treasury with ASIC and industry.

2.6.3 Voting rights of scheme members

On a show of hands, each member of a registered scheme has 1 vote.[79] On a poll, each member has 1 vote for each dollar of the value of the total interests they have in the scheme.[80] The RE of a registered scheme and its associates are not entitled to vote on a resolution at a members' meeting if they have an interest in the resolution other than as a member.[81]

One submission[82] has referred to problems raised by the voting provisions where a joint venture seeks to be registered as a managed investment scheme. Registration is sought to enable another registered scheme to invest in it. While it may not be appropriate commercially for the joint venture partners to have voting rights proportionate to their capital contributions, registration requires that voting rights are proportionate.

ASIC does not have a discretion to modify voting rights in relation to a managed investment scheme.

It would appear desirable that such investment vehicles were not denied the benefits of registration provided that investor protection and the interests of the industry as a whole were not compromised. A determination of these issues would involve the consideration of many and varied factors. It is consequently thought that legislative amendment to confer a discretion on ASIC to vary voting rights on a case-by-case basis would be more appropriate than attempting to define the types of schemes where exemption from, or modification to, the voting requirements would be warranted.

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79 Subsection 253C(1).
80 Subsection 253C(2). Section 253F sets out how to calculate the value of an interest in a scheme. Subsection 253J(1) provides that all special or extraordinary resolutions must be decided on a poll. Under subsection 253J(2), other resolutions may be decided on a show of hands unless a poll is demanded.
81 Section 253E.
82 IFSA.

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 would not be compromised.

2.6.4 Voting power of scheme members

As indicated earlier, subsection 253C(2) provides that, on a poll, each member of a scheme has 1 vote for each dollar of the value of the total interests they have in a scheme.[83] Special or extraordinary resolutions must be decided on a poll[84] and would apply to most matters on which scheme members would vote.

Members in a managed investment scheme may hold different classes of interests. A typical example is a split trust in which members may hold income or growth units entitling them to distributions of income or increases in capital value respectively. The value of the two classes of units may vary substantially according to market fluctuations with the result that one class could accrue considerably greater voting power than the other.

In this type of scheme, the interests of the two classes may conflict, so that the dominance of the interests of one class may have ongoing detrimental consequences for the other class.

One submission has raised concerns about the ability of the MIA to protect members' interests in these circumstances. It has contended that voting power should not be based on the current value of a member's units but rather on the amount a member has paid for them.[85]

This raises the issue of whether, among members of a managed investment scheme, the holders of interests having a majority value should be permitted to

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83 Under section 253F, the value of an interest is market value for a listed scheme, redemption value for a liquid scheme where withdrawal is permitted and, for other cases, an amount determined by the RE by reference to what a willing but not anxious buyer would pay.
84 Subsection 253J(1).
85 A Kernahan.

exercise their voting power to the detriment of the minority interest holders.[86] It also raises the issue of how a RE can properly exercise its duty to treat the members of different classes fairly.[87]

It could perhaps be argued that it is reasonable for voting rights to be proportionate to a member's economic interest in a scheme. Members holding interests of a much higher value than other members should have a proportionately greater say in matters of the scheme that could affect the value of their interests.

Part 2F.2 of the Corporations Act provides for the protection of holders of class rights in a company. However, the provisions of this Part do not presently apply to managed investment schemes.

In recognition of the problems involved with class interests, ASIC issued Class Order 98/60 — *Protecting class rights in a managed investment scheme*. The Class Order provides that if a scheme's constitution sets out a procedure for varying or cancelling class rights, those rights may only be varied or cancelled by a resolution under paragraph 601GC(1)(a) if the constitutional procedures have been followed. However, section 601GA does not require schemes to make provision for class rights in their constitutions so the application of ASIC's Class Order is not universal.

The problems raised by class rights in the context of members' voting powers are acknowledged. The ramifications of changes to the voting provisions in the Corporations Act could be significant. It is therefore proposed to examine the issue in more depth and in conjunction with widespread consultation.

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86 This analysis only looks at the remedies available under the Corporations Act and, in particular, the provisions of Chapter 5C. It does not examine general law remedies.

87 Section 601FC provides that a RE of a registered scheme must treat the members who hold interests of the same class equally and members who hold interests of different classes fairly.

2.6.5 Members' rights to withdraw from schemes

If members are to have rights to withdraw from a scheme, the scheme's constitution must specify the right and set out procedures for making and dealing with requests.[88]

The constitution of a registered scheme may provide for withdrawal at any time while a scheme is liquid[89] or in accordance with Part 5C.6[90] if the scheme is not liquid. If a scheme is liquid, the constitution governs how withdrawal is effected.[91] For non-liquid schemes, withdrawal must be in accordance with the scheme's constitution and sections 601KB to 601KE.[92]

Schemes are liquid if 80 per cent of the value of scheme property is liquid.[93] Money in a bank account, bank accepted bills and marketable securities are liquid assets unless it is proved that the RE cannot reasonably expect to realise them within the period specified in the constitution for satisfying withdrawal requests while the scheme is liquid.[94]

Subsection 601KA(6) extends the meaning of 'liquid' to include scheme property which the RE reasonably expects can be realised for its market value within the period specified in the constitution for satisfying withdrawal requests while the scheme is liquid.[95]

Sections 601KB to 601KE specify the procedure by which members' interests in a non-liquid scheme may be wholly or partly redeemed. Offers must be made to all members for a period of not less than 21 days.[96] No withdrawal requests may be satisfied until the offer period has closed.[97] Payment of withdrawal requests must be satisfied within 21 days after the offer closes. If the available

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88 Subsection 601GA(4). The subsection also requires a scheme's constitution to provide for exercise of redemption rights while a scheme is non-liquid in accordance with Part 5C.6. Rights to withdraw and relevant procedures must be fair to all members.
89 Subsection 601KA(1).
90 Subsection 601KA(2).
91 Paragraph 601KA(3)(a).
92 Paragraph 601KA(3)(b).
93 Subsection 601KA(4).
94 Subsection 601KA(5).
95 In other words, if a constitution specifies a 6-month period for the satisfaction of withdrawal requests, any property that the RE reasonably expects can be realised for its market value within that period can be regarded as a liquid asset.
96 Paragraph 601KB(3)(a).
97 Subsections 601KB(2) and (3).

liquid assets cannot fully meet the value of the withdrawal requests, these must be met on a pro rata basis in accordance with the formula in section 601KD.

It is possible under the MIA, for a scheme having mostly or wholly non-liquid assets to specify a period in its constitution for the satisfaction of withdrawal requests thereby qualifying as a liquid scheme.[98] As such, it would not have to adhere to the procedures for redemption of members' interests applicable to non-liquid schemes.

The provisions could possibly be used to inappropriately allow otherwise non-liquid schemes to avoid the procedures set out in sections 601KB to 601KE. It is envisaged, however, that disclosure requirements under the Corporations Act and the potentially unattractive marketing implications involved would limit the appeal of such a practice.

It is considered that the issues raised in this area should be more fully explored to determine whether legislative amendment would be appropriate and, if so, the content of such an amendment.

With regard to the reference in subsection 601KA(5) to a 'period specified', it has been suggested that subsection 601KA(5) be amended to remove any doubt that redemption in a shorter period than that provided in a scheme's constitution is possible.[99]

The subsection refers to the realisation of assets 'within the period specified within the constitution' and so already indicates the possibility of redemption within a shorter timeframe. No submissions have raised concerns about the manner and timeframe in which members' interests are being redeemed. Amendment is therefore not considered necessary.

2.6.6 Voidable contracts and rights of scheme members

Section 601MB is an important investor-protection provision. It provides that a contract entered into to subscribe for an interest in a managed investment

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98 Freehills.

99 Minter Ellison has proposed that 'maximum' be inserted before 'period' so that the subsection reads that 'The following are liquid assets unless it is proved that the responsible entity cannot reasonably expect to realise them *within the maximum period* specified in the constitution…'. (emphasis added)

scheme is voidable at the option of the acquirer if the scheme is not registered or if an offer was made in contravention of Chapter 6D, in particular, the disclosure provisions.

Section 601MB applies only to offers for subscription or invitations to subscribe in relation to interests in a managed investment scheme.

ASIC has commented that the section should also apply to the sale situations covered by section 707. Section 707 refers to the sale offers that need disclosure.[100] A distinction is made between retail investors to whom disclosure is required and wholesale investors to whom disclosure is not required.

It appears that the limitation on the ambit of section 601MB may have been an unintended consequence of modifications to other sections of the Corporations Act that were not applied to section 601MB. It would appear to make sense to require disclosure for the types of sales covered by section 707.

An amendment to section 601MB so that its ambit can be extended to sales in section 707 is supported.

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.

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100 When the changes made to the Corporations Act by the FSRA come into force, section 1012C will apply to managed investment schemes instead of section 707.