Review of the

Managed Investments Act 1998

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Review of the Managed Investments Act

3 December 2001

The Hon Peter Costello, MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

I am pleased to present the report of the Review of the *Managed Investments Act 1998*.

Submissions to the Review raised several interesting and complex issues, reflecting the diversity of views and interests across the managed investment industry. From those submissions, a number of areas have been identified where it is considered that improvements could be made to the existing arrangements for the regulation of managed investments.

In some cases, where it has not been possible to come to a conclusive view in the time available, it is suggested that further consideration of the issues should be conducted by the Treasury, in consultation with the Australian Securities and Investments Commission, industry participants, and investors and their representatives.

I would like to record my thanks for the time and effort contributed by those who made submissions to the Review, and for their willingness to provide further information when it was requested. I would also like to thank the Review Secretariat in the Financial Markets Division of the Treasury, for the assistance they provided during the Review.

Yours sincerely

Malcolm Turnbull

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Terms of reference

I, Joseph Benedict Hockey, appoint Mr Malcolm Turnbull to review the effectiveness of the arrangements for the regulation of managed investments introduced by the *Managed Investments Act 1998* (the Act), contained in Chapter 5C of the *Corporations Act 2001*, to determine whether:

- the arrangements have delivered benefits in terms of:
  - better protection of investors' investments;
  - greater certainty as to the responsibilities, obligations and liability of scheme operators (known as 'responsible entities' under the legislation);
  - the rights of investors in managed investment schemes; and
  - reducing the costs of investing in managed investment schemes.
- the arrangements have strengthened compliance practices, procedures and awareness amongst responsible entities and others involved in the managed investments industry;
- the arrangements cater for the diversity of managed investments, including consideration of the way in which the legislation is administered by the Australian Securities and Investments Commission; and
- refinements could be made (whether requiring legislative amendment or not) to enable the arrangements to operate more efficiently and effectively, while not unnecessarily detracting from the protection afforded to investors.

I have asked Mr Turnbull to deliver a written report to me by **3 December 2001**.

Executive summary

On 6 August 2001, the then Minister for Financial Services & Regulation, the Hon. Joe Hockey MP, announced the Terms of Reference for a review of the *Managed Investments Act 1998* (MIA).

The MIA commenced on 1 July 1998. Section 3 of the MIA required a review to be conducted as soon as possible following the third anniversary of the MIA's commencement, with a written report to be tabled in each House of the Parliament within six months of the anniversary date.

The purpose of the Review is to examine the effectiveness of the regulatory arrangements for the managed investment industry put in place by the MIA.

Submissions to the Review were invited from the public, and a website was established to facilitate an open and transparent review process. All submissions (other than those that were to remain confidential at the authors' request) were placed on the website, to allow interested parties to consider the views put forward by others.

Altogether, 31 submissions were received from industry participants and their representatives, professional advisers, investors' and consumers' representatives, and members of the public. A submission was also received from the industry regulator, the Australian Securities and Investments Commission (ASIC). A list of the submissions is in the Appendix to this report.

Overview

When conducting the Review, consideration was given to the fact that, up until relatively recently, the financial sector had been growing particularly strongly, and as a result, the industry had not faced significant stresses or pressures for large-scale rationalisation. Furthermore, given the two-year transitional period for the MIA, a large part of the industry had not operated under the new arrangements until well into 2000.

Notwithstanding this, several proposals emerged as warranting changes to the MIA and related provisions of the *Corporations Act 2001*, and these are contained within the report's recommendations.

A number of submissions identified perceived shortcomings with the legislation that raised more complex issues or were likely to have significant ramifications. With regard to these proposals, definitive conclusions have not been reached. In these circumstances, it is proposed that the issues be examined more fully, with further consultation by Treasury with ASIC, the industry, and investors and their representatives.

Structure of the report

The report consists of five chapters.

Chapter 1: Background to the MIA and this Review.

The opening chapter gives a brief history of the events leading to the development and introduction of the MIA, along with some comments on ASIC's role as the regulator of managed investment schemes, and a snapshot showing the diversity and structure of the industry.

Chapter 2: Investor protection

This chapter looks at issues dealing with those aspects of the MIA which are intended to protect investors' interests from inappropriate or poor management practices of scheme operators and the risk of fraud or dishonesty.

The chapter examines submissions concerning the licensing requirements of REs and whether, for example, the net tangible asset (NTA) levels required under the MIA and ASIC policy serve a practical investor-protection function. Connected with this is the debate over the role of independent custodians — whether their use should be mandatory and what their obligations should be generally and to scheme members in particular.

The chapter also looks at matters surrounding the removal of the RE including whether extraordinary or special resolutions should be required, and whether difficulties in finding suitably qualified and willing replacements can be overcome. A number of other issues are considered. These relate to the question of scheme members' liability in the event of a scheme's winding up and the rights of scheme members — their voting rights, voting power and whether schemes should be required to hold Annual General Meetings.

Chapter 3: Compliance

Compliance is an area that attracted considerable comment, ranging from praise for the compliance 'culture' that the MIA had engendered in the managed investment industry, to claims that the MIA's compliance arrangements were totally inadequate. Given the short time in which the MIA has applied across the whole industry, it has not been possible to state categorically whether compliance has been strengthened or weakened with the advent of the MIA, although there are encouraging signs that the profile of compliance has been raised.

Nevertheless, there are areas where ASIC has identified weaknesses in the compliance performance of a number of responsible entities (REs), including their monitoring of contracts with service providers, and the degree to which senior management of REs are committed to the compliance process. These matters will need to be carefully watched in the coming years.

Recommendations for improvements to existing compliance arrangements have been made, including:

- the development of standards relating to the qualifications and experience of compliance committee members;
- requiring the RE to notify ASIC and scheme members about changes to compliance committee membership;
- providing ASIC with power to remove a compliance committee member in certain circumstances; and
- a clearer application of compliance functions to the board of the RE, where the RE relies on its board to conduct compliance monitoring, rather than establishing a compliance committee.

Chapter 4: Costs

Claims made prior to the introduction of the MIA regarding the likely increase or decrease in costs that would result, have proved extremely difficult to verify. Although surveys and statistical analyses are helpful in monitoring the level of costs, they can not give a definitive picture as to whether movements in costs are attributable to the introduction of the MIA, or due to extraneous factors.

An important point made in this chapter is that the level of costs cannot be considered in isolation, but must be viewed in conjunction with the quality of compliance and investor protection that are achieved.

Recommendations aimed at delivering modest cost savings are made, including some relaxation of the requirement to treat scheme members equally, such that there will be increased scope for REs to offer differential fee structures to members.

Chapter 5: Other law reform proposals

This chapter deals with proposals for law reform of a minor and/or technical nature, and those that do not fit easily into the categories discussed in previous chapters. It contains recommendations for legislative amendment on a number of matters, generally involving issues that are clear-cut and uncontroversial.

The chapter also covers several proposals which have been recommended for further consultation. These include proposals to:

- amend the definition of *managed investment scheme* to clarify the position of redundancy funds and to expand the definition in certain respects, for example, to apply to bodies corporate that carry on investment businesses;
- amend the definition of *scheme property* to facilitate its application to primary production schemes;
- revise the application of provisions relating to continuous disclosure and related-party transactions to ensure they are appropriate for managed investment schemes; and
- revise the framework within which forfeiture of members' interests are regulated.

Recommendations

Chapter 2: 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.

Chapter 3: 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.

Chapter 4: 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.

Chapter 5: 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.

Background to the MIA and this Review

1.1 Introduction

The *Managed Investments Act 1998* (MIA) commenced on 1 July 1998. It inserted Chapter 5C into the *Corporations Act 2001* (then known as the Corporations Law) setting out new arrangements for the registration and ongoing regulation of managed investment schemes, replacing the previous prescribed interest provisions. The MIA also made various related amendments to the Corporations Act, such as the inclusion of relevant definitions, provisions relating to the licensing of operators of managed investment schemes, and provisions relating to the appointment and removal of auditors of schemes. Finally, the MIA contained provisions dealing with the transition from the prescribed interest provisions to the new arrangements.

Legislation which commenced at the same time as the MIA, the *Company Law Review Act 1998*, also inserted provisions into the Corporations Act relevant to managed investment schemes, including provisions relating to meetings of scheme members.

The MIA had its genesis in 1991, when the Commonwealth Attorney-General commissioned the Australian Law Reform Commission (ALRC) and the Companies and Securities Advisory Committee (CASAC) to prepare a report on the regulation of collective investments. That report, entitled *Collective Investments: Other People's Money*, was delivered in 1993, and included draft legislation to implement its recommendations.

The draft legislation formed the basis of the Managed Investments Bill, although various amendments were made to the Bill both prior to its introduction to the Parliament, and during debate. As part of its passage through the Parliament, the Managed Investments Bill was referred to the Parliamentary Joint Committee on Corporations and Securities (PJCCS), which also prepared a report on the legislation. The majority report of the PJCCS recommended passage of the legislation, and this occurred on 25 June 1998. It should be noted that a dissenting minority report, suggesting changes to the

Bill (some of which were taken up in the Parliament), was delivered by Senator Andrew Murray on behalf of the Australian Democrats.

The Review of the MIA which is the subject of this report arises by virtue of section 3 of the MIA, which provides as follows:

> *3(1) The Minister must cause a review of the operation of the Act to be undertaken as soon as possible after the third anniversary of the commencement of the Act.*
>
> *(2) A person who undertakes such a review must give the Minister a written report of the review, including any recommendations for changes to the regulation of managed investments.*
>
> *(3) The Minister must cause a copy of the report to be tabled in each House of the Parliament within 6 months after the third anniversary of the commencement of the Act.*

The Review received 31 submissions, which are listed in the Appendix. Given the number of other issues, including legislative changes, that are currently affecting the Australian financial system, it was encouraging to see the level of interest in the Review.

1.2 Scope of the report

The major change resulting from the introduction of the MIA was the replacement of the former dual trustee/fund manager structure for collective investments with a single responsible entity (RE). It is well known that this issue generated substantial debate.

It is not the purpose of this report to re-examine in detail the reasons for the introduction of the MIA, as the arguments for and against the legislation were considered exhaustively throughout its long gestation period.

However, in reviewing the operation of the MIA, it is instructive in some instances to refer to the history of the legislation, to help determine to what extent the predicted benefits or drawbacks of the MIA have come to be realised.

The following chapters of the report deal with the Terms of Reference, including investor protection and the rights of scheme members, compliance, costs and proposals for law reform. From the outset, it needs to be recognised that these matters are substantially interrelated, and should not be considered in isolation.

For example, it is not reasonable to separate questions about investor protection from those relating to the costs of investing in managed investment schemes. An increase in cost may be justifiable if there has been a commensurate improvement in the level of compliance and thus greater protection of investors' interests. Likewise, a decrease in costs will be of little benefit if it comes at the expense of weakened compliance arrangements which expose investors to greater risk.

The final chapter of the report contains a number of proposals for amendments to the MIA which are of a minor and/or uncontroversial nature, or do not fit neatly into the other chapters. The uncontroversial proposals are combined into a single list of recommendations. The remaining proposals involve issues where there is some divergence of opinion, and some have already been the subject of substantial discussion between the Australian Securities and Investments Commission (ASIC) and the industry. In the time available for the Review, it has not been possible to examine each of these proposals in detail. Therefore, rather than making specific recommendations on these matters individually, it is suggested they be subject to further consultation involving the Treasury, ASIC, the industry and the investing public, to decide which are worth pursuing, and the best means of implementing them.

1.2.1 Tax effective schemes

It was suggested that the Review should consider the links between the MIA and so-called 'tax effective schemes'.[1] One submission asserted that the impetus for the major provisions of the MIA was the behaviour of certain scheme promoters in the 1990s, which ultimately resulted in the recent action taken by the Australian Taxation Office in relation to tax effective schemes.[2]

While the need to regulate the activities of scheme promoters was no doubt one factor considered in the development of the MIA, a more important driver

1 Law Institute of Victoria.
2 Australian Managed Investments Association Ltd.

of the ALRC/CASAC review was the desire to clarify responsibility in instances of scheme failure, following some high-profile failures of prescribed interest schemes which had involved protracted litigation to determine where responsibility to scheme members lay, as between the fund manager and trustee.

It is not considered that there is anything inherent in the MIA framework that has directly impacted upon the initiation or proliferation of tax effective schemes. Such schemes have been a feature of the managed investment landscape in Australia dating back well before the introduction of the MIA.

Later chapters of this report consider aspects relating to investor protection and compliance by scheme operators under the MIA. However, the report does not give any special consideration to tax effective schemes. It is noted that the Senate Economics References Committee is currently conducting an Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection, and released two interim reports in June and September 2001. A final report is expected shortly, but was not available at the time of printing this report.

1.2.2 ASIC's role and resources

Submissions generally commended ASIC on the way it handled the implementation of the MIA, particularly the assistance ASIC officers provided to industry participants during the transitional period involving the licensing of REs and scheme registration.

However, it needs to be acknowledged that submissions also contained some criticism of ASIC's stand on certain issues. This is understandable, as it is to be expected that the industry regulator and industry participants will differ in their interpretation of the legislation from time to time.

ASIC's role and responsibilities have increased significantly with the advent of the MIA. Apart from the licensing of REs and registering of schemes, ASIC also conducts surveillance activities, takes enforcement action, grants relief from the law, issues policy guidance for the industry, provides information to investors and assesses their complaints, and acts as a statutory register for scheme documentation.

A number of submissions suggested that ASIC did not have adequate resources to carry out the functions required of it under the MIA.[3] ASIC itself has stated that *'(B)ecause 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 proactive way — by undertaking surveillance, providing guidance or by adjusting policy settings'*.[4]

ASIC noted that it is currently engaged in a detailed process to estimate the resources required for managed investment work in the future, as part of a Pricing Review which it is conducting in conjunction with the Department of Finance and Administration.

It is stating the obvious to say that ASIC should be adequately resourced to carry out its functions under the MIA effectively. However, it would not be appropriate for this Review to recommend a particular level of funding. Funding decisions for statutory agencies such as ASIC must be made by the Government in the context of its overall fiscal position, taking into account all the competing claims on the Budget. At the agency level, ASIC must similarly make resource allocation decisions for each of its functions, within the constraints of its overall funding allocation. In this regard, the Pricing Review process should serve to assist ASIC in determining the appropriate allocation of its resources.

1.3 Timing of the Review

As mentioned, the MIA contained transitional provisions designed to make the change from the previous prescribed interest provisions of the Corporations Law to the new regime as smooth as possible. These transitional arrangements extended up to two years from the MIA's introduction. As a result, for a large part of the industry, the new arrangements did not come into full effect until well into 2000.

While the Review is intended to examine the first three years of the MIA's operation, in reality, much of the industry has been subject to the new arrangements for a much shorter period of time. For this reason, it has been

3 Minter Ellison, Trust Company of Australia Limited, and Trustee Corporations Association of Australia.

4 ASIC — part one.

difficult to make definitive statements regarding the performance of the MIA in certain areas. In effect, therefore, this is not a three-year review of the operation of the MIA, but rather a review of its operation over varying periods depending on when schemes transitioned to the new arrangements.

The point has also been made that since the MIA commenced, the investment climate in Australia has been relatively favourable, and the new arrangements have not been subjected to any significant stress. During this time Australia has not experienced any widespread or major failure of managed investment schemes. It has been argued that these factors make it difficult to determine whether investor protection has, in fact, been enhanced or diminished.[5]

By the same token, the relatively short period in which the MIA has been in full effect could also be used to argue against the more definitive claims that the new arrangements have been unsuccessful. For example, some have pointed to ASIC's surveillance statistics as evidence that compliance practices in the industry are poor.[6] However, it is worth noting that the surveillance activities conducted by ASIC under the MIA were more focussed on compliance systems and structures than the surveillances undertaken under the previous prescribed interest regime. Moreover, given the short length of time the industry as a whole has been subject to the MIA, it is probable that the compliance statistics reflect, in a large part, an industry that is still coming to grips with the MIA's compliance requirements, and improvements can be expected as experience with the new arrangements develops.

1.4 Current state of the managed investment industry

1.4.1 Diversity of schemes

The MIA undoubtedly covers a broader range of collective investment vehicles than was the case under the prescribed interest provisions. The Corporations Act, and in particular, Chapter 5C, have sought to achieve flexibility in the application and administration of the managed investment regulatory regime, largely through the conferral of discretionary powers on ASIC.

5 Trust Company of Australia Limited.
6 Trustee Corporations Association of Australia.

ASIC's broadest discretions are conferred by section 601QA which provides that ASIC may exempt a person from a provision of Chapter 5C, or declare that the chapter applies to a person as if specified provisions were omitted, modified or varied.

There was not a great deal of comment in submissions on the ability of the legislation to cater to the diversity of schemes. However, those that did comment generally considered the MIA had sufficient flexibility in this regard, and supported ASIC's use of its modification powers.[7] This view was not universal however. It is acknowledged that certain REs consider that the new regime is not appropriate for the nature of the scheme they operate.[8]

Figures provided by ASIC show that, of the 2,827 schemes registered as at 16 August 2001, the more traditional financial assets schemes dominate, although there are a reasonable proportion of property, primary production, mortgage and master fund schemes. Time sharing, film, derivative and strata schemes account for only a very small portion of the industry.

However, ASIC commented that the smaller, non-mainstream end of the market accounted for a disproportionately large use of its resources. Of 137 Class Orders granted during the transitional period, 81 related to specific types of managed investment schemes. ASIC had also developed specific policies to assist with the application of the legislation to serviced strata schemes, mortgage schemes, time sharing schemes and IDPS-like schemes.

This might be seen to accord with comments made in one submission that schemes at the smaller, more exotic end of the market did not appear to have transitioned well.[9] However, it is not unexpected that such schemes would find the transition difficult, as in most cases they were subject to little, if any, regulation prior to the introduction of the MIA. Many of the more mainstream schemes, on the other hand, were subject to regulation under the prescribed interest provisions, and their operators therefore had some familiarity with both the Corporations Act and with ASIC's predecessor, the Australian Securities Commission.

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7 Ernst & Young and Commonwealth Bank Group.
8 The President’s Club Limited.
9 Ernst & Young.

ASIC has proposed changes to the legislation to better cater to the diversity in the industry. These are discussed elsewhere in this report. They deal with:

- the definition of *scheme property* in section 9 (Chapter 5);
- requirements applying to scheme property (Chapters 2 and 5); and
- the transfer of rights and liabilities to new REs (Chapter 5).

As a final point, it should be noted that, in the interests of allowing for diversity in the industry, the MIA is not intended to prescribe the type of vehicle under which schemes should be structured.

Notwithstanding this, it appears that some confusion may have been caused by subsection 601FC(2) which provides that the RE 'holds property on trust for scheme members'. One submission has commented that the provision should be re-drafted to remove any confusion over whether schemes are intended to be constituted as trusts.[10] This is discussed in Chapter 5.

1.4.2 Industry structure and profile

As at 16 August 2001, there were 441 licensed REs operating some 2,827 registered managed investment schemes.[11] Chart 1 and Table 1 show the trend in RE and scheme numbers since the introduction of the MIA.[12] They amply demonstrate the effect of the MIA's transitional period, showing a substantial increase in RE licensing and scheme registration in the run-up to 30 June 2000.

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10 Freehills.

11 ASIC — part one.

12 Source: ASIC — part one, appendix 2.1.

Chart 1: Growth of managed investment industry

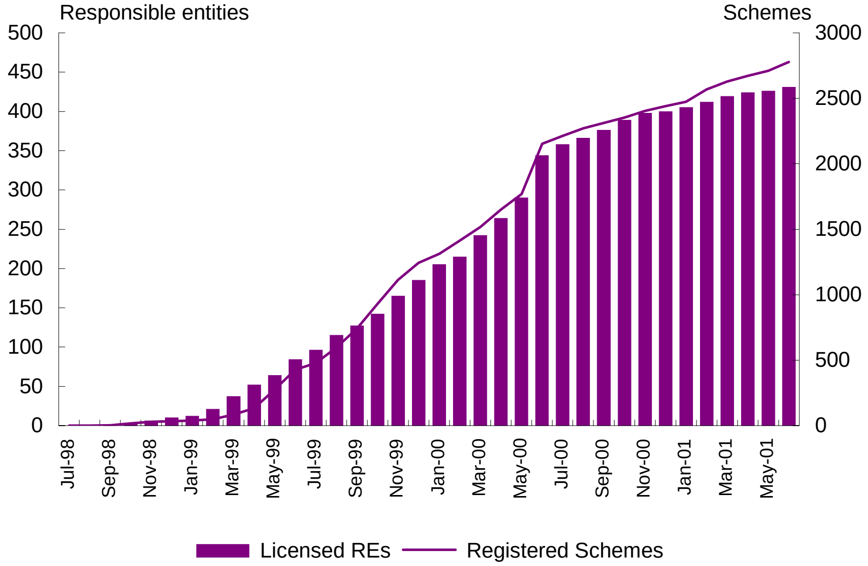

Table 1: Growth of managed investment industry

Month	Licensed REs	Registered schemes	Month	Licensed REs	Registered schemes
Jul-98	0	0	Jan-00	205	1314
Aug-98	0	0	Feb-00	215	1415
Sep-98	1	2	Mar-00	242	1518
Oct-98	3	18	Apr-00	264	1650
Nov-98	6	29	May-00	290	1770
Dec-98	10	33	Jun-00	344	2152
Jan-99	12	38	Jul-00	358	2214
Feb-99	21	49	Aug-00	366	2270
Mar-99	37	85	Sep-00	376	2311
Apr-99	52	133	Oct-00	389	2352
May-99	64	274	Nov-00	398	2403
Jun-99	84	428	Dec-00	400	2441
Jul-99	96	477	Jan-01	405	2475
Aug-99	115	597	Feb-01	412	2568
Sep-99	127	740	Mar-01	419	2629
Oct-99	142	928	Apr-01	424	2671
Nov-99	165	1112	May-01	426	2710
Dec-99	185	1243	Jun-01	431	2778

Managed investment schemes cover a wide variety of business activities, ranging from investment in financial assets such as shares and bonds, to primary production ventures, time sharing arrangements as well as property and mortgage schemes. The following charts and tables show the breakdown of licensed REs and managed investment schemes based on the nature of the scheme or the underlying assets.[13]

Chart 2: Industry profile of licensed responsible entities as at 16 August 2001

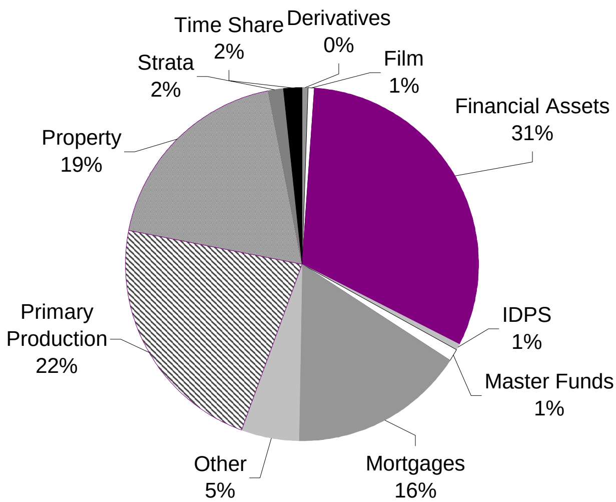

Table 2: Industry profile of licensed responsible entities as at 16 August 2001

Industry type	# of responsible entities
Derivatives	2
Film	3
Financial Assets	138
IDPS	3
Master Funds	5
Mortgages	71
Other	23
Primary Production	99
Property	83
Strata	7
Time Share	7

13 Source: ASIC — part one, appendices 2.2 and 2.3.

Chart 3: Industry profile of registered schemes as at 16 August 2001

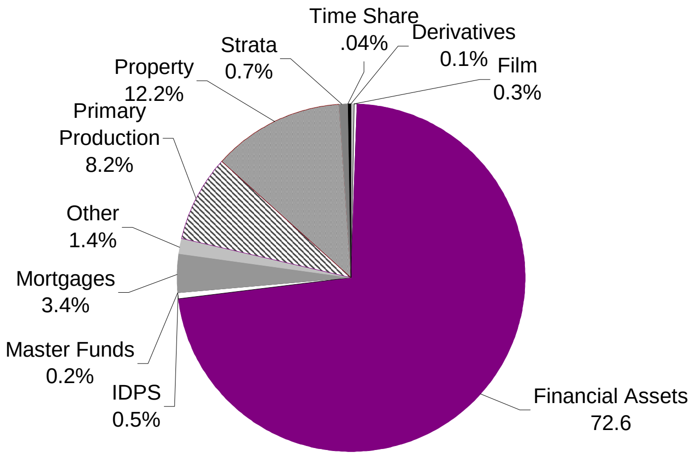

Table 3: Industry profile of registered schemes as at 16 August 2001

Industry type	# of schemes
Derivatives	4
Film	9
Financial Assets	2052
IDPS	14
Master Funds	5
Mortgages	96
Other	39
Primary Production	233
Property	345
Strata	20
Time Share	10

ASIC does not presently collect statistics on the value of assets held by managed investment schemes under the MIA (although a recommendation to require REs to disclose scheme asset values in annual returns has been made in Chapter 5 of this report). It is therefore difficult to give a precise figure showing the overall size of the industry regulated under the MIA. However, an approximate figure can be calculated from the statistics published on public unit trusts and cash management trusts by the Australian Bureau of Statistics.[14] As at 30 June 2001, total consolidated assets of public unit trusts and cash management trusts, stood at approximately $154 billion. This has risen from approximately $90 billion when the MIA began on 1 July 1998.

14 ABS publication *Managed Funds*, Catalogue No. 5655.0.

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

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

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

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.

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.

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.

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,

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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.

expenses or charges, commissions that may impact on returns, and significant taxation implications.[71]

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

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

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.

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

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.

Compliance

3.1 Introduction

Under the MIA, a registered managed investment scheme must have a compliance plan, setting out the measures that the RE is to apply to ensure the operation of the scheme complies with the Corporations Act and the scheme's constitution.[1] There is also a requirement that the compliance plan be audited.[2] The role of monitoring the RE's adherence to the compliance plan rests with its board, where that board has a majority of external directors.[3] Where this is not the case, a compliance committee must be established to undertake compliance monitoring. If a compliance committee is used, it must have at least three members, the majority of which must be external members.[4] Compliance committees are required to regularly assess the adequacy of the compliance plan, and are also required to report to the RE breaches of the Corporations Act or the scheme's constitution, and report to ASIC if those breaches are not adequately addressed by the RE.[5]

There was a broad range of opinion in the submissions on the effectiveness of the compliance arrangements under the MIA. While REs themselves have argued that there has been an increased focus on compliance under the MIA, this has also been observed by others involved in the managed investment industry, with many claiming that the compliance 'culture' has improved with the introduction of the MIA.[6]

However, the degree of compliance under the MIA regime has received some criticism. These criticisms include allegations that the compliance plan audit is an 'after-the-event' process, which does not materially add to investor protection, given the existing safeguards of a majority independent board or a

1 Section 601HA.
2 Section 601HG.
3 External director is defined in subsection 601JA(2).
4 External member is defined in subsection 601JB(2).
5 Section 601JC.
6 For example, Ernst & Young and Paul Dortkamp.

compliance committee monitoring compliance.[7] The 'after-the-event' nature of audit and regulatory checking was also highlighted as a more general failing of the MIA's compliance arrangements.[8]

3.2 Compliance to date under the MIA

While it is not possible for a compliance regime, however strict, to totally eliminate breaches of the legislation or a scheme's constitution, it is encouraging that a number of submissions affirmed the increasing profile of the compliance function within REs. However, because regulatory surveillance of compliance was not conducted prior to the MIA, it is not possible to point to survey data that indicate an improvement (or deterioration) in compliance. That said, ASIC's Information Release on 2000-01 surveillance outcomes[9] indicates that there is still room for improvement in compliance practices, particularly among smaller participants in the industry. ASIC's survey resulted in remedial action being taken against 69 of the 83 REs surveyed, including revocation of dealer's licences in four cases.[10]

In commenting on these statistics, ASIC noted that the commitment shown by senior management to the compliance process, and the standard of compliance reporting, required considerable improvement in many REs.

However, against this background it needs to be appreciated that ASIC's surveillances were 'targetted', with the majority being conducted in those areas where ASIC anticipated there would be compliance problems. The statistics show that small schemes (defined by ASIC as those with less than $50 million under management) accounted for well over half of the number surveyed. Within this category, there was a particular focus on mortgage and agricultural schemes.

It also warrants noting that the 2000-01 financial year was the first year that the MIA regime had been in full effect, following the two-year transitional period to the new arrangements. Therefore, it is likely that a number of participants in the industry were still coming to grips with the new compliance requirements. Improvement in compliance could be expected as participants

7 Freehills.
8 Trustee Corporations Association of Australia.
9 IR 01/09, *2000-2001 Surveillance Outcomes for Responsible Entities*, 1 August 2001.
10 REs must have a dealer's licence in order to operate a managed investment scheme.

gain more experience with the process and compliance procedures are further developed.

Nevertheless, there are areas where it is considered that the compliance arrangements can be strengthened, and these are set out in the following sections.

3.3 The compliance committee

3.3.1 Qualifications and experience of compliance committee members

One perceived weakness of the compliance arrangements raised in submissions was the lack of minimum standards or 'benchmarks' regarding the qualifications and/or experience of compliance committee members.[11] At present, as long as a majority of members of the compliance committee are external, there are no further requirements to determine whether committee members have the requisite competence and skill to carry out their duties as required under the legislation.

It is acknowledged that bodies such as the Independent Compliance Committee Members' Forum (ICCMF), which was established specifically for the purposes of the MIA, and the Association of Compliance Professionals of Australia (ACPA), which deals with compliance issues more generally, have increased the awareness and understanding among compliance committee members of their role and responsibilities. These bodies provide a useful service by facilitating the exchange of views among the compliance fraternity.

However, there is some concern that the membership and audience of these bodies is concentrated primarily at the more sophisticated end of the managed investment industry. To a large degree, this is a natural consequence of the location of REs and the managed investment schemes they operate. That is, the more sophisticated REs are generally based in capital cities, making it more convenient for compliance committee members to participate in activities organised by the ICCMF and ACPA. Therefore, these compliance committee members gain the benefit of networking with others in the industry to a greater degree than members from more remote locations.

11 Freehills.

Thus there is evidence that the 'pool' of people with the appropriate skills to serve on a compliance committee may be somewhat restricted in certain parts of the industry. In any event, it is considered that a case exists for some form of standards to be developed across the whole managed investment industry, to ensure that compliance committee members have knowledge and skills appropriate to the type of managed investment scheme(s) with which they are associated.

It is not intended that standards be prescribed in legislation. It is likely that qualifications and experience requirements will vary depending on the nature of schemes. For example, the skills required of a compliance committee member for an agricultural scheme may differ from those required for a scheme investing in financial assets.

To provide the necessary flexibility, it would be preferable for the standards to be developed cooperatively through consultation between ASIC and the industry. This consultation should also determine the appropriate mechanism to impose the standards. For instance, they could be prescribed by way of a condition on the licence of a RE to operate a managed investment scheme, or be developed as an ASIC Policy Statement.

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.

3.3.2 Appointment, removal and retirement of compliance committee members

Currently, there is no requirement for REs to notify ASIC when they appoint or remove a member of a compliance committee, or when a committee member retires. It was argued in one submission that this is a factor which adds to the insecurity of tenure of those members, and thereby may compromise their independence.[12] Another submission suggested that the introduction of rules governing the appointment and dismissal of compliance

12 Trust Company of Australia Limited.

committee members would increase the likelihood that those members will act upon breaches of the constitution and the Corporations Act, as required under section 601JC.[13] While not necessarily endorsing these views, it is considered important that ASIC and scheme members are made aware of the identity of compliance committee members, and are informed when those members are being appointed or removed, or when they retire.

This would provide ASIC with an additional tool in targetting its compliance surveillance. For example, if compliance committee members were continually being replaced by a RE, this may be a factor indicating tension between the compliance committee and the RE in relation to the operation of the scheme, which might warrant further examination by ASIC.

The requirement to notify ASIC could be based on existing requirements in the Corporations Act relating to notification of the appointment, removal or resignation of directors of a company.[14]

Knowledge of the identity of compliance committee members, and changes to the composition of the committee, would also be useful information for scheme members. Having said that, it is recognised that there are costs involved in notifying scheme members, particularly in large schemes, and that notification every time the membership of a committee changes would be impractical. Therefore, it is considered sufficient if scheme members are notified of changes to compliance committee membership on a yearly basis. This notification could be incorporated within the scheme's annual report.

Another means of more widely publicising the identity of compliance committee members would be for their names to be accessible on the ASIC website. The feasibility of this option should be investigated.

ASIC has noted that there would be a cost to 'build' the capability to enable such information to be available on its website and it would result in ASIC forgoing fees, especially if other information relating to schemes, such as copies of scheme compliance plans and constitutions (currently available at a cost) were also made freely available. In this regard, ASIC has also noted that information relating to company directors is currently not available free of cost, and has posed the question whether more 'free' information should be

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13 Freehills.
14 Sections 201L and 205B.

available on managed schemes than on corporations. Such a question begs a wider, but more significant one — should there, in the Internet age, be any charge for accessing corporate and similar information filed with ASIC?

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.

Going beyond mere notification, should ASIC have formal powers in relation to the appointment or removal of compliance committee members? In respect of the appointment of members, while recognising that little information about compliance committee membership is currently in the public domain, it is not considered that there is sufficient evidence of inappropriate appointments being made to warrant giving ASIC the power to formally approve appointments. In any event, the development of standards relating to qualifications and experience (Recommendation 10) will provide informal appointment criteria.

There is arguably a stronger case for ASIC to have power to remove a member of a compliance committee, where it is not appropriate for that person to continue to serve on the committee. This might arise, for example, where it becomes apparent in the course of a scheme surveillance by ASIC that a member of a compliance committee has failed to carry out his or her statutory duties effectively.

This failure may be because the person is not actively participating in the work of the committee, which may in turn be due to inexperience or lack of qualifications (although published standards should reduce the likelihood of this). A case for removal might also arise where a compliance committee member has been convicted of an offence, the nature of which would make it inappropriate for the person to continue to serve on a compliance committee, regardless of his or her qualifications or experience.

As a general rule, the RE itself should take action where it becomes aware that a compliance committee member is not adequately performing his or her duties, or where it is otherwise inappropriate for that person to continue to serve on the compliance committee. However, giving a power to ASIC to act in such cases will provide an added incentive for the RE to be vigilant in ensuring the compliance committee membership is appropriate at all times.

It is recognised that removal of a compliance committee member by ASIC has the potential to adversely affect the person's standing in the business community and his or her reputation more generally. Given this, persons subject to a decision by ASIC to remove them from a compliance committee should have the right to apply for a review of the decision by the Administrative Appeals Tribunal.[15]

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.

3.3.3 Non-individual members on the compliance committee

A number of submissions suggested that an external corporate entity should be allowed either to sit on a compliance committee, or to assume the full compliance monitoring function.[16] Some suggested that an external compliance entity should be mandatory, while others put it forward as an alternative to maintaining a board with a majority of external directors, or a compliance committee made up of individuals.

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15 Part 9.4A of the Corporations Act provides for review of ASIC decisions by the AAT, including decisions made under the managed investment provisions in Chapter 5C.

16 Minter Ellison, Trust Company of Australia Limited, Trustee Corporations Association of Australia, and Law Council of Australia.

As discussed previously, at what might be called the more sophisticated end of the managed investment industry, there appears to be a sufficiently large pool of appropriately experienced and qualified people available to sit on compliance committees. However, this may not be the case for schemes which are rurally or regionally based, such as agricultural schemes and mortgage schemes, which are generally operated by smaller REs. It is possible that if Recommendation 10 relating to the development of standards for compliance committee membership is implemented, the pool of available people in this segment of the industry will diminish further.

In light of this, the proposal to allow the RE to engage an external party, (whether a body corporate or some other entity such as a partnership), to conduct compliance monitoring has some appeal. In particular, it may provide a useful alternative for those smaller REs that currently have difficulty in finding individuals to serve as compliance committee members. However, this proposal raises a number of issues:

- It is likely to be most attractive to smaller, less sophisticated REs and there is a danger that they may effectively outsource their compliance responsibilities, and focus less attention on compliance issues. This would be at odds with the MIA's rationale that the RE takes ultimate responsibility for all aspects of the operation of the scheme, including compliance.

- There is a possibility that a compliance entity which is large relative to the RE may come to dominate the RE. This could similarly undermine the central requirement of the MIA that the RE must operate, and have responsibility for, the scheme. Ultimately, however, the RE would have the power to dismiss the compliance entity.

- It would introduce more complexity into the compliance arrangements, such that there would be three possible compliance structures — a board with a majority of external directors, a compliance committee made up of individuals, or a compliance entity.

- To be effective, certification of the appropriateness of the entity chosen to perform compliance monitoring, in terms of the qualifications and experience of its staff, would be required. In particular, it would be necessary to ensure that the individuals on whose experience and qualifications the entity achieved certification actually undertook the compliance duties, rather than delegating them to more junior staff lacking the requisite skills.

- It is evident from the surveillance statistics that ASIC has found problems during surveillance visits relating to the implementation of compliance and the monitoring of external service providers. There could be a compounding of problems if a significant part of the compliance function was effectively outsourced.

As discussed in section 3.2, the industry is still adapting to the MIA's compliance arrangements. There is certainly room for improvement but overall it is suggested the trend is in the right direction.

Therefore, at this stage, it does not appear that the level of demand or need for change would outweigh the possible negative effects that could arise as a result of such a significant change to the compliance framework. However, if compliance performance (judged by ASIC's surveillance statistics) does not show sufficient improvement in the next few years, implementation of the proposal to allow REs to engage an external compliance entity at their discretion, would be warranted.

3.3.4 External members of compliance committees

Certain criteria must be met in order for a director of the RE to qualify as an external director, or a person to qualify as an external member of a compliance committee.[17]

Presently, a person is ineligible to be an external director of a RE, or an external compliance committee member, if he or she has a material interest in the RE or a related body corporate. This ineligibility extends to the person's relatives. However, relatives of people who are ineligible for other reasons (for example, because they are employees of the RE or are involved in business dealings with the RE) are not themselves ineligible.

17 Set out in sections 601JA and 601JB respectively.

It has been suggested[18] that the relatives of any person ineligible to be an external director of a RE or an external member of a compliance committee should themselves be ineligible.

It has also been argued[19] that the ineligibility criterion based on a person's material interest in the RE or a related body corporate would benefit from clear standards as to what constitutes 'material'. It was suggested that materiality could be based on whether a person has an interest with an independently verifiable value exceeding a modest fixed amount.

Another criterion for ineligibility applies to a member of a partnership that is, or has been in the past 2 years, involved in business dealings or in a professional capacity with the RE or a related body corporate. It has been suggested that this unfairly prejudices members of accounting and legal firms, and should be removed.[20]

It is difficult to gauge the impact of these suggested changes, both in terms of their effect on the continuing eligibility of current external directors of REs and external members of compliance committees, and more generally in terms of the appropriate degree of independence from the RE that should be required of such directors and committee members. In view of this, it is not proposed to make a recommendation on these changes. Nevertheless, it is important that further consideration be given to these proposals to ensure that the criteria for external directors and external compliance committee members strike an appropriate balance between the need for independence and the opportunity for appropriately qualified people to serve on the board or compliance committee.

3.4 The board of the responsible entity

The legislation contains requirements in relation to the functions and procedures of the compliance committee, and the duties of compliance committee members. It also prescribes matters that the compliance plan must contain in relation to compliance committee arrangements. However, it contains little guidance relevant to the situation where the RE has a board with

18 ASIC — part two.
19 ASIC — part two.
20 Freehills.

a majority of external directors that undertakes the compliance-monitoring role.

More particularly, the legislation requires that the compliance plan must contain arrangements for ensuring that the compliance committee functions properly, including adequate arrangements for membership of the committee, how often committee meetings are held, and the committee's reports and recommendations to the RE.[21] ASIC has suggested that similar requirements, to the extent appropriate, be applied to the board of the RE where the board conducts compliance monitoring.

The legislation also sets out the compliance committee's functions, and places specific duties on committee members.[22] While there are also specific duties placed on officers of REs[23] (which includes the board of directors), there is no reference to the functions of the board in its compliance monitoring role.

It is acknowledged that there are other provisions in the Corporations Act of general application to company directors.[24] Nevertheless, it is considered important that directors of a RE that undertake the compliance monitoring function in relation to managed investment schemes give due attention to their responsibilities in this regard. This would be reinforced if there were specific requirements in Chapter 5C.

Certain modifications would need to be made to apply the current provisions relating to the compliance committee to the board of directors of the RE. For example, the compliance committee is required to report to the RE any breaches of the compliance plan. It would be nonsensical for the board of the RE to report to itself. Nevertheless, a requirement for the board to take action to remedy breaches it becomes aware of in its compliance monitoring role should be considered. For example, the Board might be specifically required to document the breach in the minutes of its meeting and specify what follow-up action it plans to take, and the result of that action.

21 Paragraph 601HA(1)(b).
22 Sections 601JC and 601JD.
23 Section 601FD.
24 For example, Part 2G.1 relating to directors' meetings.

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.

3.5 The compliance plan and scheme constitution

3.5.1 Incorporation of provisions by reference into compliance plans and constitutions

The law currently allows a RE to lodge a compliance plan with ASIC which incorporates certain provisions (as in force at a specified time) of the compliance plan of one of its other schemes.[25] ASIC has modified the operation of this provision such that specified provisions, as they are in force *from time to time*, may also be incorporated by reference.[26] This provides the procedure with more flexibility. ASIC has suggested that the content of this modification be included in the legislation itself, and this is supported.

While the 'incorporation-by-reference' provision has proved useful, it has been suggested that incorporation of provisions by reference be permitted from a 'model' compliance plan, that is, a plan that is not specific to a particular scheme.[27] This would overcome the current limitation on incorporation by reference which, because it is linked to the compliance plan of an existing scheme, means that all schemes referring to that plan need to modify their compliance plans if the existing scheme is terminated.

This proposal would not seem to have any adverse effects for investor protection, but rather is a change that will improve administrative efficiency. However, in implementing such a change, it would be important to ensure that REs continue to monitor compliance on an individual scheme basis, even though they may lodge a model compliance plan. In this regard, a model compliance plan should not be seen as a 'one size fits all' or template plan which is routinely applied to each and every scheme. Rather, it is envisaged

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25 Section 601HB.
26 ASIC Class Order 98/50.
27 Minter Ellison and IFSA.

that the model plan would contain a broad range of provisions from which selections could be made and applied to individual schemes.

The MIA is clearly predicated on compliance being conducted on a scheme-by-scheme basis. The suggested changes should not relieve REs of the obligation to lodge a compliance plan for each scheme they operate. However, those individual plans would be able to incorporate part (or all) of the provisions of a model plan.

Further, any change should not make it more difficult for members of a scheme to gain access to copies of the consolidated compliance plans for the individual scheme(s) they invest in. That is, investors should not have to follow a trail of references through a number of documents or different locations on a website in order to familiarise themselves with a scheme's compliance plan.

Copies of scheme compliance plans may be requested from ASIC, for a fee. However, there is presently no ability for a scheme member to request a copy of the compliance plan from the RE. This is in contrast to scheme constitutions, which members may seek a copy of, on payment of a fee.[28] Members should be provided with a similar right to request a copy of the compliance plan from the RE.

Arguments in support of an 'incorporation-by-reference' provision have also been raised in relation to the scheme constitution.[29] Unlike compliance plans, there is currently no provision in the legislation for a scheme constitution to incorporate provisions from the constitution of another scheme operated by the same RE.

It would seem sensible to extend the incorporation-by-reference provisions to scheme constitutions. Likewise, there may be merit in drafting this provision to allow incorporation from a 'model' constitution. However, this must be subject to the same caveats as mentioned in relation to model compliance plans, namely, that any change should not diminish the RE's responsibility to monitor the appropriateness of constitutions on an individual scheme basis, and members should have access to a consolidated copy of the individual constitutions for the scheme(s) they invest in. In this regard, it would be worthwhile clarifying that the right for members to request a copy from the RE

28 Subsection 601GC(4).
29 Minter Ellison, IFSA, and Ernst & Young.

of a scheme's constitution under subsection 601GC(4) refers to a consolidated copy.

It is understood that some REs make scheme documents such as compliance plans and constitutions available to members free of charge (for example, on a website). This is to be commended and encouraged as best practice throughout the industry.

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 or 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.

3.5.2 Compliance plan audit

ASIC put forward suggestions for law reform relating to the audit of the compliance plan,[30] including that:

- the auditor of the compliance plan should be required to address the audit report to the members of the scheme, on the basis that the report contains

30 ASIC — part two.

useful information to members, who should be entitled to rely on it — currently the compliance plan auditor is only required to give the audit report to the RE;[31]

- the auditor's opinion should relate to whether the compliance plan was adequate at all times throughout the year, not just as at the last day of the year — there is some uncertainty as to the correct interpretation of the existing provision;[32]

- when a scheme is registered, an audit should be carried out on the compliance plan and lodged with ASIC within a period of, say, 9 months, rather than the period currently provided for under the legislation, which may be up to 21 months from the date of scheme registration;[33]

- an opinion of a registered company auditor that the compliance plan is adequate should be required as part of the documentation accompanying an application to register a scheme;[34] and

- the legislation should clarify that the audit of the compliance plan must focus on 'material' issues. Further guidance on the issue of materiality was also called for in another submission.[35]

These proposals, which ASIC has stressed should be considered as a package of measures, are worthy of further consideration. While they may impact on the costs faced by a RE, they have the potential to substantially enhance investor protection. However, they also affect the liability and duties of auditors of compliance plans, and it is important that auditors be given adequate opportunity to comment on the proposals. It is therefore suggested that these matters be progressed through consultation involving the Treasury, ASIC, the auditing profession and other interested parties.

31 Subsection 601HG(3).
32 Subparagraph 601HG(3)(c)(ii).
33 The 21 month period comes from a combined reading of subsection 601HG(7), which requires the audit report to be lodged at the same time as the scheme financial statements; section 323D, which provides that the first financial year for a scheme may last for a period up to 18 months from registration; and section 314 and subsection 315(3), which provide that schemes must report to members within 3 months of the end of the financial year.
34 Subsection 601EA(4) lists the documents currently required to accompany an application for scheme registration.
35 Ernst & Young.

It has been argued in one submission that the audit appointment for a compliance plan should be made on a firm, rather than an individual basis, as making the appointment personal to an individual auditor caused difficulties for audit firms in reassigning workloads as and when required.[36] The submission suggested that the prohibition in subsection 601HG(2) against the auditor of the compliance plan also auditing the RE's financial statements be reconsidered — the law currently prohibits the same individual conducting both audits, but does not preclude auditors from the same firm being engaged. In contrast, another submission was somewhat concerned by the fact that the auditor of the RE's financial statements and the compliance plan may come from the same firm.[37]

It is recognised that the current arrangements for audit appointments for the RE's financial statements and the compliance plan are something of a compromise, aimed at providing a measure of independence between the two audits, while not unreasonably preventing the RE from using the same audit firm for both purposes. Despite the arguments (on both sides) mentioned above, it is not felt that there is enough evidence to warrant alteration of the current requirements for audit appointments.

3.6 Other compliance-related matters

3.6.1 Insurance for compliance committee members

The legislation prohibits a RE, or a related body corporate, from paying insurance premiums on behalf of compliance committee members, where the insurance covers the committee member for breaches of his or her duties.[38] According to one submission,[39] there is some uncertainty as to whether this prohibition means that compliance committee members must seek their own insurance, or whether they can be included under the RE's existing insurance policy for directors and officers. If the former interpretation is correct, it is suggested that many potential compliance committee members will be deterred by the high cost of seeking insurance. On the other hand, it is argued that the addition of compliance committee members to the existing directors'

36 KPMG.
37 Trust Company of Australia Limited.
38 Section 601JG.
39 Paul Dortkamp.

and officers' policy would result in little, if any, increase in the overall premium.

The rationale behind the requirement that REs not pay insurance premiums on behalf of compliance committee members is to reinforce their independence from the RE, and ensure that they are personally responsible for their actions. However, it is appreciated that the cost of seeking insurance may, in some circumstances, discourage suitable people from taking up the position of a compliance committee member.

This issue may require further investigation to determine whether the concerns expressed above are widely held. Therefore, it is suggested that the matter be considered by Treasury and ASIC, in consultation with representatives of compliance committee members.

3.6.2 Policy guidance for compliance committee members

It has been suggested that further policy guidance is required on various issues relating to the compliance committee, including its relationship with the RE and other parties, such as the compliance plan auditor.[40] Examples of such issues include the extent to which the compliance plan auditor should be 'directed' by the compliance committee, as opposed to the RE who actually appoints the auditor.

Although Part 5C.5 sets out the functions of the compliance committee and the duties of its members, and the regulations also contain some requirements concerning the relationship between the compliance committee and the RE,[41] it is acknowledged that there may be issues which require more detailed policy guidance. These issues are unlikely to be amenable to prescription in the legislation itself. It is therefore suggested that consultation take place between ASIC and relevant parties to consider the scope of guidance required, and the best means of providing it — whether by way of ASIC policy statements or some other mechanism.

40 KPMG (see also Ernst & Young).

41 Regulation 5C.5.01 places obligations on the RE, its officers, agents and officers of agents to assist the compliance committee, for example, by allowing the committee access to books of the scheme.

Costs

4.1 Introduction

There are two sides to the issue of costs. On the one hand, there is the cost of investing in a managed investment scheme, which includes entry, exit and ongoing management fees borne by scheme members. On the other hand, there is the cost of operating a scheme, including the cost of complying with relevant legislation, which is borne in the first instance by the scheme operator. Of course the two aspects are intimately related. The cost of operating a scheme will be reflected in the fees charged to investors and/or the returns they receive on their investment. Competitive pressures also have the potential to influence costs, as they may lead to scheme operators absorbing some of the costs they might otherwise pass on, in order to build or maintain a market presence.

A great deal of attention was focussed on costs during the debate and passage of the MIA. Proponents of the new arrangements claimed that substantial cost savings could be achieved by the replacement of the dual trustee/fund manager structure with a single RE, and that this would translate into lower fees and charges for investors. Critics of the MIA were equally adamant that the compliance arrangements would not only offset any cost savings from the removal of the dual structure, but would increase ongoing costs. They also pointed to the cost of transitioning to the MIA regime.

It is likely that both sides of the debate over-played the impact on costs, particularly given the difficulty in obtaining consistent and comparable quantitative evidence. This is due to a number of factors — most importantly, the lack of a single parameter that serves as a reliable indicator of the cost of investment. Although management expense ratios (MERs) are often taken as a proxy of the cost of investing, they rarely encompass the full range of fee and charge structures in a managed scheme. This leads to difficulties in making comparisons between schemes, and even within the same scheme over time.

A related difficulty is attempting to disentangle the 'true' cost of investing from other factors that impact upon managed schemes. Up until relatively recently, the financial sector had been growing particularly strongly, and as a result, there had not been a major catalyst for a large-scale rationalisation of costs within the investment industry. That said, while conditions have been buoyant, the competition within the industry has acted to ensure that the effect of extraneous factors, such as the Y2K 'bug', has been relatively muted. However, such factors add to the difficulty in making a definitive statement on whether costs have risen or fallen as a result of the implementation of the MIA.

4.2 Costs cannot be considered in isolation

A theme that runs throughout this report is that the central aspects of managed investments are interrelated, and cannot be viewed in isolation. Costs are a particularly good example of this interrelationship, being closely connected with issues of compliance, competition, consumer choice and investor protection.

Even if it could confidently be said that the cost of investing had risen or fallen under the MIA, this alone would not reveal a great deal. A decrease in costs is of little benefit if it comes at the expense of reduced investor protection. Likewise, an increase in costs due to compliance requirements may be justifiable if there have been improvements in the management and administration of schemes, which has enhanced investor protection.

It is felt that undue emphasis may have been given to costs, by both sides of the debate, during the development and implementation of the MIA, and not enough attention focussed on the integration of costs with other aspects of investing in a managed scheme.

4.3 Analyses of costs

Despite the concerns expressed earlier about the difficulties in reaching a definitive view on the effect on costs flowing from the introduction of the MIA, it is nevertheless instructive to consider the studies that have been conducted in this area.

The submission from the Investment and Financial Services Association Limited (IFSA) included a report on Retail Registered Schemes Fees and

Charges.[1] The report found that, for the period 1996 to 2000, there had been an overall reduction in the weighted average MER of 3.92 per cent (or 6 basis points), translating to an annual cost saving of approximately $53.3 million. From the commencement of the MIA on 1 July 1998, the report found an overall reduction in the weighted average MER of 2 per cent (or 3 basis points), translating to an annual cost saving of $26.8 million.

The report acknowledged that the available data did not permit a quantitative analysis of access and advice fees, due to a number of factors which influenced the exact entry fee paid by an investor, such as rebates provided by an investment adviser. Nevertheless, the report concluded that over the period studied, the potential cost to an investor had reduced due to widespread rebating by fund distributors and the evolution of low-cost distribution channels such as discount brokers.

While these findings are encouraging, they raise the obvious question of whether the cost reductions arose as a result of the implementation of the MIA, or whether they would have occurred in any event. In this regard, it is apparent from the report findings that costs were trending downward prior to the MIA's introduction.

The submission from the Australian Consumers' Association (ACA) questioned whether cost savings had eventuated, noting that it had considered fee statistics for several Australian equity funds over the period in which the transition to the MIA took place.[2] While acknowledging that the funds selected did not constitute a representative list, the ACA considered that the statistics showed that fees had not been significantly reduced during the transition from the dual trustee/fund manager structure to a single RE.

The ACA suggested that this Review of the MIA should consider, on the basis of independent research, the movement in MERs and fees generally for investors in the transition to the MIA regime.

It was not seen as the role of this Review to commission research into fees. However, it is noted that at least one independently funded body, the Centre of Corporate Law and Securities Regulation (CCLSR), which is part of the

1 Prepared for IFSA by KPMG.
2 Using data from Morningstar, the ACA considered MERs for selected Australian equity funds (data for 2001 was not available).

University of Melbourne, is currently conducting research into the governance of managed investment schemes, including the collection of information on the costs of implementing the mandatory compliance structures required under the MIA.[3] At the time of printing of this report, the CCLSR had not yet reported its findings.

4.4 Measures to reduce costs

Although it cannot be stated categorically that the costs of investing in managed investment schemes have fallen as a result of the introduction of the MIA, there are nevertheless options to consider that may reduce the costs of complying with the MIA, and which do not detract from investor protection.

4.4.1 Differential fees

An area which has the potential to deliver fee reductions for certain investors relates to the ability of REs to offer different fee structures to members of managed schemes. Presently the legislation provides that the RE of a registered managed investment scheme must treat members who hold interests of the same class equally, and members who hold interests of different classes fairly.[4] To date the ability of REs to charge differential fees has been severely limited by the use of the word *equally* in the legislation, which ASIC has correctly interpreted as largely preventing such arrangements.

Earlier this year ASIC published a Class Order[5] providing relief from the equal treatment provisions to enable limited differential fee arrangements. That Class Order generated a number of submissions to ASIC seeking extensions to the permitted categories of differential fee arrangements. Submissions to this Review have similarly suggested that differential fee arrangements be liberalised.[6]

In a supplementary submission to the Review ASIC noted that the requirement to treat members of the same class *equally* made it difficult to appropriately consider differential fee arrangements, and suggested it may be preferable if

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3 The CCLSR project is funded by the Australian Research Council.
4 Paragraph 601FC(1)(d).
5 Class Order 01/50, 17th January 2001.
6 Commonwealth Bank of Australia, Freehills, Minter Ellison and IFSA.

the requirement was made more flexible, such as a requirement to treat members of the same class *fairly*, as already applies in respect of members of different classes. However, ASIC did not advocate a simple replacement of the equality test with a fairness test.

Rather, ASIC considered that any changes should be subject to certain requirements. Firstly, investors need to be provided with adequate disclosure so that they are able to compare the effect of differential fee arrangements, both between different fee structures offered by the same offeror, and among different offerors. This is supported.

The FSRA, which takes effect on 11 March 2002, amends the Corporations Act to implement new requirements in relation to the disclosure of fees and charges relating to financial products, which include interests in managed investment schemes. Disclosure of the type suggested by ASIC is entirely consistent with the objectives of the FSRA, and to the extent that any additional disclosure requirements are considered necessary as a result of a change from an equality test to a fairness test, they could be accommodated under the FSRA framework.

Secondly, ASIC suggested that it may be necessary that fairness be interpreted by reference to some economic justification. For example, a differential fee arrangement must be reasonable having regard to the difference between the cost incurred by the RE in providing services to any member who is a party to a differential fee arrangement, and the cost incurred in providing services to any member who is not a party to the arrangement. ASIC further suggested that imposing a disclosure requirement in relation to this measure might also be an effective regulatory tool. While not necessarily objecting to this aspect of ASIC's proposal, further consideration needs to be given to whether this measure is warranted and, if so, how best to implement it.

The question of what is fair will naturally be open to interpretation. Examples of fair differential fee arrangements might include:

- fees based on a difference in service (such as higher fees charged for the provision of additional member statements); or

- lower entry fees charged to a member making a very large investment, on the basis that the investment enables the scheme to take advantage of economies of scale, resulting in overall lower fees for all members.

An example of an unfair differential fee arrangement might arise where a RE offers lower fees to a related party on a totally arbitrary basis, with no benefit to other scheme members.

Between these fairly obvious examples, there are likely to be many grey areas, but this should not deter efforts to provide further guidance on this issue.

ASIC proposed that further discussion be held on whether interpretational assistance to a fairness test should be included in the legislation itself or in ASIC policy.

The issue of differential fees is not a new one, and ASIC and the industry have already engaged in extensive dialogue about it. Nevertheless, industry should be given an opportunity to consider the proposals put forward by ASIC in its supplementary submission. Therefore, ASIC's suggestion that further discussion take place is supported, not only in relation to where interpretational material relating to the fairness test should be located, but also as to the nature and content of that material.

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.

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

Some submissions raised as an issue the circumstances in which a number of trusts or schemes may be registered as a single managed investment scheme, rather than requiring individual registration.[7] It was argued that this would have an impact on costs, given that scheme registration attracts a fee.[8] The submissions suggested that ASIC has shown some reluctance to register several trusts or schemes as a single scheme.

A recommendation was made in Chapter 3 regarding the lodgement of 'model' compliance plans and scheme constitutions. It is considered that this initiative may provide some modest cost savings for REs. However, that recommendation is subject to REs continuing to assess the adequacy and appropriateness of compliance plans and constitutions on an individual scheme basis. Therefore, it does not follow that the use of model compliance plans and constitutions can be taken to imply that the schemes or trusts that make use of such models are so closely related that they can be considered a single scheme.

ASIC has noted[9] that it is administratively impractical to regulate arrangements based on whether a scheme promoter subjectively envisages several trusts as part of the one scheme, and considers there may be a loss of investor protection if a scheme constitution provides the ability to create additional unit trusts ad infinitum. It is agreed that this is an important consideration, and once again demonstrates the interrelationship between cost and investor protection.

ASIC suggested that either the definition of *managed investment scheme*[10] be amended to clarify that there must be a substantial degree of interdependence in the benefits to members in order for several trusts or schemes to be considered as one scheme, or that section 601ED relating to scheme registration be amended to provide ASIC with a power to determine when several trusts or schemes may be registered as one scheme. In the latter scenario, the explanatory material accompanying the legislative change would make clear that ASIC would exercise this discretion based on the degree of interdependence and economic relationship between the trusts or schemes.

It is accepted that an amendment to the legislation is warranted, in order to provide a more solid foundation on which decisions relating to registration of

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7 Minter Ellison and IFSA.
8 The current registration fee is $1800 per scheme.
9 ASIC — part two.
10 Section 9.

multiple trusts or schemes can be made. Of the two options put forward by ASIC, the second is preferred, on the basis that it allows for greater flexibility. Persons whose interests are affected by ASIC's decisions should be able to apply to the Administrative Appeals Tribunal for a review of the decision.[11]

Regardless of which option is pursued, it will be necessary for some guidance to be provided as to what will constitute a substantial degree of interdependence between trusts or schemes. It is suggested that this is best done by way of ASIC policy, rather than legislative prescription, as the concept of interdependence may require tailoring, depending on the nature of the trusts or schemes involved.

It is acknowledged that differences of opinion will continue to arise between ASIC and promoters of schemes and their representatives in relation to the registration of multiple trusts or schemes as a single scheme. Nevertheless, it is felt that a more transparent statement of ASIC's discretion in this matter, coupled with guidance from ASIC as to how that discretion will be exercised, will provide greater certainty of approach, and assist in resolving any disputes that may arise. It is expected that this, in turn, will lead to some cost savings.

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.

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11 Part 9.4A of the Corporations Act provides for AAT review of certain ASIC decisions, including those made under the managed investment provisions of Chapter 5C.

4.4.3 New responsible entities assuming obligations under contracts entered into by their predecessors

Circumstances may arise where a new RE assumes permanent or temporary control of a managed investment scheme, and the new RE believes that the maintenance of existing obligations and liabilities to agents of the former RE may not be in the best interests of scheme members. This could, for instance, be an important consideration in situations where the scheme may be under financial strain due to maladministration by the former RE. In particular, inherited contractual arrangements may hinder the new RE in taking steps to reduce outlays, and return the scheme to financial viability.

Under the legislation, where the RE of a registered managed investment scheme is changed, the rights, obligations and liabilities of the former RE so far as they relate to the scheme, become the rights, obligations and liabilities of the new RE subject to certain limited exceptions.[12] Similarly, references to the former RE in documents under which it acquired or incurred a right, obligation or liability are taken to be references to the new RE.[13] Although the matter is not totally free from doubt, the preferred interpretation of the legislation is that the new RE 'inherits' contracts entered into by the former RE with an agent or other person appointed under subsection 601FB(2) to perform functions in connection with the scheme.

Two submissions to the Review argued that there should be scope for a new RE (including a temporary RE) to elect whether or not to assume the contractual obligations entered into by its predecessor.[14] Such contracts can operate to entrench the position of a RE, as onerous contractual obligations may deter entities from agreeing to take over the RE role. Thus, a RE can effectively frustrate the ability of members to replace it in cases where it may be underperforming. The potential for this situation to arise is perhaps greatest where the agents with whom the former RE has contracted are related to the former RE.

Nevertheless, the rights of parties who contract with a RE in good faith and at arm's length need to be considered. An unfettered right for a new RE to disinherit contracts entered into by its predecessor may deter entities from

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12 Section 601FS.
13 Section 601FT.
14 ASIC — part two, and a confidential submission.

contracting with REs in the first place, or lead to their seeking greater protection of their position, increasing the cost of the contract to the RE and, indirectly, the scheme members.

In July 2000, ASIC released for comment a draft Information Release[15] relating to this issue, in which it proposed draft Class Order relief to allow a new RE to avoid inheriting contracts made by the former RE with its agents. In particular, it proposed that the new RE could give an agent notice within one month after becoming RE that it did not wish to inherit the contract, whereupon the rights, obligations and liabilities under contracts made between the agent and the former RE would revert to the former RE. However, in the period between assuming the role of RE and giving notice to the agent, the rights, obligations and liabilities would rest with the new RE.

Another option put forward in the draft Information Release was that the new RE should be required to give notice to the agent before it becomes the RE, in which case the rights, obligations and liabilities under any contract with the agent would always remain with the former RE. The draft Class Order made it clear that the former RE would not have a right of indemnity out of the scheme property for liability to an agent due to the change of RE. The draft Class Order also specified that the right for a new RE to elect not to inherit contracts would not apply if the new RE was a related body corporate of the former RE.

ASIC did not proceed with the draft Class Order relief, partly no doubt in acknowledgement of the complex issues that arise in relation to the protection of the rights of agents who contract with REs.

Where contracts are entered into by an entity with a RE in the knowledge that the RE may be replaced, or where the contract is otherwise not made in good faith or at arm's length, there is a clear case to allow the new RE to elect not to take over that contract.

However, there may also be situations where it is not appropriate for the new RE to disinherit a contract with an agent of a former RE. For example, in the situation mentioned in ASIC's draft Class Order, where the new RE is a related body corporate of the former RE, it would be difficult to argue that the new RE should have a right to disinherit contracts, although the basis for this would be

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15 IR 00/23.

the relationship between the former and new REs, rather than an explicit recognition of the need to protect the rights of the other party to the contract.

The disinheritance of a contract by a new RE should not affect the validity of the contract as between the agent and the former RE, and the agent would still have rights against the former RE. Nevertheless, in many instances, a right of action under the contract (such as a claim for damages or specific performance) against the former RE will be of little value, for example, where the former RE is insolvent.

While in practice the removal of a RE should occur relatively infrequently, the issue of the inheritance of contracts has important ramifications which require detailed consideration. It is agreed in principle that new REs should, in some circumstances, have the right to elect not to inherit contracts relating to a managed investment scheme that were entered into between a former RE and its agents. However, further thought needs to be given to whether this should be an absolute right, or whether there are situations in which it is not appropriate for contracts to be disinherited. Therefore, it is suggested that further consultation take place between Treasury, ASIC and the industry to progress the matter.

Other law reform proposals

5.1 Introduction

Submissions to the Review contained a number of proposals for changes to the managed investment provisions in Chapter 5C and related parts of the Corporations Act. Many of these have been discussed in earlier chapters.

The remainder comprise proposals for relatively minor or technical legislative amendments, or deal with issues that do not fit neatly within the subject matters covered by earlier chapters. These have been divided into two groups in this chapter.

Where the issues appear clear-cut and non-controversial, the relevant proposals are supported and discussed in section 5.2.

Where the issues are multi-faceted, and are likely to have far-reaching implications or raise conflicting views across the managed investment industry, the proposals are discussed in section 5.3. It would have been premature to form a conclusive view on these issues, within the time available for this Review. Many of these issues require substantial research and/or may pose practical difficulties in implementation. These need to be more fully explored to determine whether legislative intervention would be appropriate and, if so, how the desired aims could be most effectively achieved.

Therefore, for these more far-reaching proposals for law reform further consultation is recommended. This consultation should involve the Treasury, ASIC, the managed investment industry, and investors and their representatives, with a view to assessing their merit before any legislative intervention. Thought would also have to be given to the practicalities of implementing proposals that are considered worthwhile.

The proposals in sections 5.2 and 5.3 are grouped according to their subject matter and, unless otherwise indicated, were put forward by ASIC. Each proposal is followed by as brief an explanation of the issues as the subject matter allows. Legislative references are to the Corporations Act.

5.2 Law reform proposals supported

The following proposals for law reform are supported.

5.2.1 The Compliance Committee

- Amend subsection 601JB(3) to insert 'and paragraph 4(a)' after '(2)(a)'; and
- Amend subsection 601JB(4) to insert 'or a related body corporate' after 'responsible entity'.

The effect of these amendments will be to incorporate into the legislation relief which has been granted by ASIC, such that a person is not taken to be substantially involved in business dealings, or in a professional capacity with a RE, merely because they are an external director of a related body corporate, or a member of a compliance committee of a registered scheme operated by a related body corporate. Without this relief, such persons would be disqualified from being an external member of a compliance committee.

- Extend section 601JE to apply to former compliance committee members.

Section 601JE provides compliance committee members with qualified privilege in respect of statements concerning the operation of a scheme made to the RE or ASIC. However, the provision does not apply once a compliance committee member resigns or is replaced. This may lead to reluctance on the part of former compliance committee members to provide information to the RE, or more particularly to ASIC, for fear of attracting liability. This is an undesirable outcome, and the extension of the protection is warranted.

5.2.2 Directors of responsible entities — disclosure of interests

- 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.

Section 205G requires directors of a listed company to notify the relevant securities exchange of their interests in securities of the company or related bodies corporate, and of contracts that confer rights to interests in managed investment schemes made available by the company or related bodies corporate. However, if a managed investment scheme is listed, but the RE is not, then the directors of the RE are not subject to disclosure requirements.

The predecessor of section 205G contained a requirement for disclosure in situations where the scheme was listed but not the RE.[1] It appears that this requirement was inadvertently omitted when the section was amended.[2] Although it is understood that the Listing Rules of the Australian Stock Exchange are being amended to rectify this omission, it is felt the obligation is important enough to warrant specific inclusion in the legislation.

5.2.3 Definition of managed investment scheme

- Amend the definition of *managed investment scheme*[3] to exclude class actions and costs paid for legal proceedings.

Under the rules of the Federal and other Courts, participants in a class action may make payments to solicitors acting in the matter, so that they can be party to any favourable judgement. ASIC has received requests for relief from the operation of the managed investment provisions in Chapter 5C for such arrangements. While it is arguable whether class action arrangements fall within the definition of *managed investment scheme*, it is suggested the matter be put beyond doubt. Matters relating to the conduct and funding of class actions are more appropriately dealt with under the Rules of Court.

5.2.4 Definition of scheme property

- Amend the definition of *scheme property*[4] to clarify when property ceases to be scheme property.

This proposal is supported in the interests of providing greater certainty. ASIC has suggested that property should cease to be scheme property when it is paid to scheme members, or to the RE as a fee or indemnity under subsection 601GA(2), or where it is no longer held by the RE or its agents or appointees under section 601FB, unless a constructive trust arises. Situations in which a constructive trust is taken to arise may require some specification.

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1 Former subsection 235(1A).
2 By the *Corporate Law Economic Reform Program Act 1999*.
3 Section 9.
4 Section 9.

5.2.5 Restrictions on the size of partnerships and associations

- Amend section 115 so that it does not apply to registered managed investment schemes.

Section 115 provides that a partnership or association with more than 20 members must incorporate, subject to a limited exception. It is considered that this requirement is inappropriate where the partnership or association is a registered managed investment scheme, as the regulation of such schemes is an acceptable substitute for the regulation that would apply if the partnership or association was incorporated.

5.2.6 Annual returns

- 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 amount of their interest, so far as it relates to members of investor-directed portfolio service (IDPS)-like schemes (as defined in ASIC PS 148) or, alternatively, give ASIC discretion to determine an approved form for the annual return.

Section 349 sets out the content requirements for a managed investment scheme's annual return. There is currently no requirement for the return to disclose the value of scheme property. This information would assist ASIC in keeping track of the total vale of assets managed in registered schemes, and its disclosure in the annual return will not place a burden on REs, who should be monitoring the value of scheme property for their own purposes.

The requirement to reveal the identity of the top 20 interest holders and the value of their interests is similar to the requirement applying to the top 20 shareholders in a company.[5] While this requirement has benefits in terms of transparency, ASIC feels that it unnecessarily intrudes upon the privacy of interest holders in IDPS-like schemes. IDPS-like schemes acquire and hold investments and involve arrangements for the custody of assets and consolidated reporting. They include most products marketed as master funds

5 Section 348.

or wrap accounts. An important feature of IDPS-like schemes is that the investor makes all the investment decisions.

The Corporations Act contains provisions which provide power for ASIC (including at the request of a scheme member) or the RE to request information about the interests of members of a managed investment scheme.[6] It is not considered that the requirement to identify the top 20 interest holders of IDPS-like schemes in the annual return provides any additional benefits which outweigh the intrusion upon the privacy of those interest holders.

IFSA's submission supported removal of the requirement to disclose the top 20 interest holders of managed investment schemes in the annual return, particularly noting its undesirable effects for members of IDPS-like schemes.

As an alternative to amending the content of the annual return, ASIC has suggested that it be given discretion to determine the content (that is, discretion to determine an approved form for the annual return). Although no submissions have raised proposals for changes to the annual return other than those mentioned above, giving ASIC a discretion may provide greater flexibility to deal with any changes that may become necessary in the future.

5.2.7 Scheme constitution — calculation of issue price

- Amend paragraph 601GA(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').

Paragraph 601GA(1)(a) requires the constitution of a registered scheme to make 'adequate provision for the consideration that is to be paid to acquire an interest in the scheme'. An argument has been advanced[7] that ASIC's policy requirement for 'an independently verifiable price'[8] exceeds the ambit of paragraph 601GA(1)(a).

It would be desirable to resolve the apparent uncertainty regarding the ambit of paragraph 601GA(1)(a) by legislative amendment, particularly in view of its

6 Part 6C.2 (sections 672A to 672F).
7 Freehills.
8 Refer to ASIC PS 134, paragraph 134.19.

importance to investor protection. (It is intended that the amendment will not affect the operation of the relevant ASIC Policy Statement or Class Orders.[9])

5.2.8 Regulations — modification and incorporation into the Corporations Act.

- Incorporate the following regulations into Chapter 5C, with the modifications mentioned:
  - Regulation 5C.2.02 provides that ASIC, or a member of a registered scheme, may apply to the Court for the appointment of a temporary RE if ASIC or the member believes it is necessary to protect scheme property or the interests of members. This regulation does not require modification, but the provision is important enough to warrant its inclusion in Chapter 5C itself.
  - Regulation 5C.4.01 permits a compliance plan, or a modified compliance plan, lodged with ASIC under section 601HC or subsection 601HE(3), to be signed by an agent of the directors of the RE, so long as the authority to do so, or a copy of the authority verified by a director of the RE, is attached to the compliance plan or modification. It should be made clear in Chapter 5C itself that agents may sign a compliance plan or modification of the plan in the circumstances mentioned.
  - Regulation 5C.4.02 requires agents of the RE, and officers of those agents, to assist auditors of the compliance plan, for example, by allowing the auditor access to any books or information relating to the scheme held by the agent. This requirement to assist auditors should be extended to other persons engaged by the RE under section 601FB.[10]
  - Regulation 5C.5.01 requires REs, their officers, agents and officers of agents to assist the compliance committee, for example, by allowing

9 ASIC PS 134 deals with the constitutions of managed investment schemes. Paragraph PS 134.19 sets out ASIC's policy requirements under paragraph 601GA(1)(a). Relief from these requirements is provided in Class Order 98/52. A summary of the instances when Class Order 98/52 will apply is in paragraph PS 134.20.

10 Subsection 601FB(2) gives the RE power to appoint an agent, *or otherwise engage a person*, to do anything that the RE is authorised to do in connection with the scheme.

the committee access to books or information relating to the scheme. This requirement to assist the committee should be extended to other persons engaged by the RE under section 601FB.

– Regulation 5C.11.06 provides that, in determining the RE's liability to scheme members under subsection 601FB(2) for an act or omission of an agent, any amount recovered by way of indemnity from the agent under subsection 601FB(4) is to be disregarded. This regulation does not require modification, but it should appear in section 601FB itself.

- Regulation 5C.11.05A should be deleted as its contents have already been incorporated into subsection 601ED(2).[11]

The suggested modifications to the regulations are minor but warranted. It is felt that their placement in the legislation itself will give them greater prominence and is more in keeping with the subject matter involved.

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;

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11 An amendment to subsection 601ED(2) was contained in the *Treasury Legislation Amendment (Application of Criminal Code) Act (No.1) 2001.*

- 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.

5.3 Law reform proposals requiring further consideration

The following law reform proposals involve issues which deserve further consideration and consultation.

5.3.1 The responsible entity

- It should be made clear that only the RE may operate a scheme (including promoting, offering interests in, or inviting contributions to a scheme, as well as all ongoing activities and winding up) and no other person may take any part in the operation of the scheme except as an agent of, or as a person engaged by, the RE.

Arguably section 601FB already makes this clear, but ASIC is concerned that allowing other parties to contract directly with members is inconsistent with the RE concept, and the issue should be put beyond doubt.

- Subsection 601FC(2) should be amended to clarify that the RE holds scheme property on trust for members, and any agents appointed by the RE, or sub-agents, hold scheme property on trust for the RE.

Subsection 601FC(2) provides that the RE 'holds property on trust for scheme members'.

There is a concern that subsection 601FC(2) does not clearly create an *obligation* for the RE to hold scheme property on trust for members and that it fails to make clear that it is the RE, rather than members, for whom agents or sub-agents would hold scheme property.

Subsection 601FC(3)[12] refers to the 'duty' under subsection 601FC(2) so it could be argued that an obligation has, in fact, been created by the legislation.

However, the exact nature and ambit of the obligation is unclear.

It has been argued that the provision should be redrafted to remove any confusion over whether or not a scheme is intended to be constituted as a trust with the RE as a trustee of scheme property for scheme members.[13]

It is agreed that the provision could be drafted more clearly to spell out the legal relationships involved in the holding of scheme property whether by the RE or by an agent or sub-agent. Given the importance of this provision and the legal complexities involved, a more in-depth exploration of the issues is thought necessary before taking further action.

- Paragraph 601FC(1)(d) should be amended to require that members must be treated equally in relation to interests they have that confer substantially the same right to benefits produced by the scheme and the same obligations, and all members must be treated fairly. Essentially this would define a 'class' of members, such that class differentiation must be based on the rights attached to an interest, rather than purely on a member's characteristics. Other references to 'class' in Chapter 5C should be consequentially amended.

This proposal needs to be considered in conjunction with Recommendation 15 in Chapter 4 that the equality test in paragraph 601FC(1)(d) should be changed to a fairness test, in so far as it relates to differential fee arrangements.

12 Subsection 601FC(3) provides that a duty of a RE under subsection (1) or (2) overrides any conflicting duty an officer of employee of the RE has under Part 2D.1.

13 Freehills.

5.3.2 Definition of *managed investment scheme*

- Amend the definition of *managed investment scheme* to clarify whether redundancy funds come within the definition.

Redundancy funds involve an arrangement under which employers make contributions to a scheme (including under an award or agreement) the primary objective of which is to fund redundancy entitlements and other incidental benefits for employees. There is some uncertainty whether these schemes come within the definition of *managed investment scheme*.

Provided the arrangements are genuinely used to fund employees' redundancy entitlements, it is considered that they should not be regarded as managed investment schemes. However, it is understood that there are a number of variations in arrangements, including some which allow employees to also contribute moneys to the scheme, and others which allow for benefits to be paid other than on redundancy. The question becomes — at what point do such arrangements take on the character of a managed investment scheme?

Consideration needs to be given to whether an exclusion for redundancy funds from the definition of *managed investment scheme* should be drawn narrowly, such that the 'sole' purpose must be to fund redundancy benefits, and that only employers may contribute, or whether it would be sufficient if the funding of redundancy benefits was the 'primary' or 'dominant' purpose, but not necessarily the only purpose.

- Amend the definition of *managed investment scheme* to include bodies corporate that carry on an investment business, other than merely incidentally to another business.

Investment companies are currently required to be licensed securities dealers under the Corporations Act. However, when companies offer securities in investment businesses (except as interests in managed investment schemes), they are not subject to the requirements (including the provisions relating to investor protection) of Chapter 5C. It is submitted by ASIC that this provides a regulatory distortion. ASIC argues that companies carrying on investment businesses (except when incidental to their other activities) should not be excluded from the coverage of the definition of *managed investment scheme*.

However, because it is unclear how many businesses would be affected by a change along the lines suggested, comments should be sought on this proposal.

- Amend the definition of *managed investment scheme* by adding at the end of paragraph (e) words to the effect that — 'and no members:
  - hold an interest on trust except where the only beneficiaries are such bodies corporate: or
  - have acquired their interest as an acquirer under a custodial arrangement as defined in section 1012IA.'[14]

Paragraph (e) of the definition of *managed investment scheme* provides that the definition does not include 'a scheme in which all the members are bodies corporate that are related to each other and to the body corporate that promotes the scheme'. ASIC has argued that the intention of this exclusion is undermined if some person unrelated to the scheme promoter indirectly acquires an interest in the scheme. For example, a member of a registered scheme may acquire an indirect interest in a scheme that is excluded by paragraph (e) of the definition where the RE of the registered scheme invests some of that scheme's funds in the excluded scheme.

Subsection 601FC(4) provides that the RE of a registered managed investment scheme may only invest property in another managed investment scheme if it is also registered. This is designed to ensure that the protection afforded to investors under Chapter 5C can not effectively be avoided by a RE of a registered scheme investing in an unregistered scheme. However, where a scheme falls outside the definition of *managed investment scheme* because it is specifically excluded by paragraph (e), the protection afforded by subsection 601FC(4) does not apply.

Having said this, it needs to be acknowledged that some submissions argued that subsection 601FC(4) is unnecessarily restrictive. Not only was it suggested that the subsection does little to enhance investor protection, it results in wholesale managed investment schemes having to register in order that they

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14 Section 1012IA will be inserted into the Corporations Act by the FSRA. It will commence on 11 March 2002, and deals with arrangements under which a person can instruct another person to acquire a financial product.

can accept money from retail schemes, which is considered inappropriate. Those submissions have either suggested that further exceptions from the subsection be provided,[15] or that it be repealed altogether.[16] ASIC is adamant that subsection 601FC(4) is an essential anti-avoidance provision, the absence of which would substantially lessen investor protection. It is also noted that a similar provision applied under the former prescribed interest arrangements.[17]

5.3.3 Definition of *scheme property*

- Amend the definition of *scheme property* to specifically include an interest in the land necessary for the operation of a primary production scheme, for the duration of the scheme.

There is a concern that investors in primary production schemes, who do not usually have a proprietary interest in the land on which the scheme is operated, may be vulnerable to the land being taken by others with a legal right to do so, such as liquidators, mortgagees and transferees of the land owner. ASIC has sought to address this issue by way of a licence condition on REs of agricultural schemes. However, objections have been received from the industry, which ASIC is currently considering. A number of complex issues are involved, including taxation and stamp duty matters, which need to be worked through before deciding on the nature of any amendment.

- Amend the definition of *scheme property* to expressly include property to which a time sharing scheme relates.

It is suggested by ASIC that the definition of *scheme property* is based on paragraph (a) of the definition of *managed investment scheme*, and is not adequately adapted to the definition of *time sharing scheme*.[18]

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15 Some exceptions are already provided in ASIC Class Order 98/55.

16 Constellation Capital Management Limited, Freehills and Minter Ellison.

17 Former Corporations Regulation 7.12.15 prescribed certain covenants that were taken to be included in approved deeds of prescribed interest schemes. One of these covenants provided that money available for investment under the approved deed could only be invested in other prescribed interests if there was also an approved deed in respect of those interests.

18 Section 9.

5.3.4 Termination of auditor appointment on winding up of scheme

- Section 331AD should be repealed.

Section 331AD provides that the auditor of a managed investment scheme ceases to hold office where the scheme is to be wound up, or where the members vote to remove the RE, but do not at the same meeting appoint a new RE. In respect of the termination of the auditor's appointment on a wind-up, the section is similar to that applying to the winding up of a company.[19] However, unlike a company wind-up, which is generally under the control of an official liquidator, the wind-up of a managed investment scheme is conducted by the RE.

In view of this, it is argued that it is inappropriate to terminate the appointment of the scheme auditor when a wind-up commences. Rather, the appointment should continue until the wind-up is completed, and consideration should be given to including a specific requirement in the legislation that the winding up process be audited. Consideration also needs to be given to whether arrangements for the termination of the audit appointment are still required in non-winding up situations, such as current paragraph 331AD(d), where the members remove the RE, but do not appoint a replacement.

5.3.5 Related party transactions

- The provisions in Part 5C.7 should be amended so that the restrictions are more appropriate for the types of investment arrangements used by managed investment schemes.

- Section 601LD should be amended to provide that Chapter 2E applies as if section 211 (as well as the other sections mentioned) were omitted.

Part 5C.7 applies the related party transaction provisions for public companies in Chapter 2E, with certain modifications and omissions, to transactions in managed investment schemes.

19 Section 330.

The purpose of the provisions is to protect members' interests by requiring their prior approval of certain transactions involving scheme property. The transactions involve the giving or the receipt of a financial benefit by the RE or a related party,[20] out of scheme property or that could endanger members' interests.

Not all transactions involving payments out of scheme property need member approval. In Chapter 2E, member approval is not required for the following:

- section 213: the giving of a financial benefit of a maximum of $2,000 (or greater amount as prescribed by the regulations) to the director of a public company or the director's spouse;
- section 214: the giving of a financial benefit by a body corporate to a closely-held subsidiary of the body or by a closely-held subsidiary of a body corporate to the body or an entity it controls; and
- section 224: voting by a related party of the public company or an associate of such a related party on a proposed resolution which would permit the giving of a financial benefit to the related party.

Section 601LD provides that Chapter 2E applies as if sections 213, 214 and 224 were omitted. The effect of this provision is that, contrary to the situation in Chapter 2E, prior approval of members of a registered scheme is required before the giving of the benefits referred to in these sections.

ASIC has suggested that section 211 should be included as an additional 'omission' in section 601LD. This would mean that member approval would be needed before a financial benefit of the type referred to in section 211 could be given.

Section 211 refers to a financial benefit, comprising reasonable remuneration or payment of expenses incurred or to be incurred, given to an officer or employee of a public company or a related party.[21]

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20 Namely, an entity that the RE controls or an agent of the RE.

21 Section 211, in the context of Part 5C.7 of Chapter 5C, would apply to a financial benefit given to an officer or employee of the RE, an entity controlled by the RE or an agent of the RE.

In proposing this amendment, ASIC has commented that it is difficult to see when it would be reasonable to provide a benefit out of scheme property in the circumstances to which section 211 applies.

The Law Council of Australia has expressed concerns with the whole of Part 5C.7. It has argued that the drafting of Part 5C.7 by reference to Chapter 2E has resulted in legally uncertain provisions which are not appropriate for application to managed investment schemes. Additionally, the provisions impact adversely on member protection.

The Law Council has proposed that Chapter 5C.7 be amended so that the RE of a registered scheme will only be able to confer a financial benefit on itself or a related party in certain limited circumstances.[22]

The points raised in both ASIC's and the Law Council's submissions are considered to warrant further examination.

5.3.6 Continuous disclosure

- Section 1001B should be amended:
  - so that it does not apply to unlisted managed investment schemes which do not have a redemption or withdrawal facility; and
  - to apply to other managed investment schemes having scheme property with a value over a certain specified amount.

Section 1001B imposes continuous disclosure obligations on unlisted disclosing entities in relation to information that is not generally available, that a reasonable person would expect to have a material effect on the price or value of ED securities of the entity if the information were generally available. If such information is not required to be included in a supplementary or a replacement disclosure document, the disclosing entity must lodge a document containing the information with ASIC.

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22 These are that: the benefit must be conferred on arm's length terms; the benefit must be expressly permitted by the scheme's constitution and has been disclosed to members prior to being given; the benefit must be conferred on the RE or a related party in its capacity as a member of the scheme and on terms applicable to members generally; or the entity receiving the benefit is also owned by the members of the scheme (for example, stapled securities).

There are several types of ED securities. The ED securities which would include unquoted interests in a managed investment scheme are defined in section 111AF.[23] Section 1001B would most commonly apply to unlisted managed investment schemes.

ASIC has commented that references to price or value in section 1001B are inappropriate for unlisted schemes with no redemption facility. It has suggested exempting such schemes from the operation of the section and either relying on continuous disclosure or ongoing disclosure provisions. ASIC favours reliance on the ongoing disclosure obligations in section 1017B which will be introduced into the Corporations Act by the FSRA. However, section 1017B as it is currently drafted does not apply to managed investment schemes.

As for continuing disclosure obligations for other managed investment schemes under section 1001B, ASIC does not believe that the reference to member numbers in the definition of ED securities to which section 1001B refers, is appropriate. It has proposed an amendment so that the section will apply to schemes on the basis of the value of scheme property rather than member numbers. However, this could lead to the result that schemes with high member numbers but low individual investment rates would not attract the disclosure provisions whereas a scheme having few members but high individual investment rates would attract the disclosure provisions.

5.3.7 Aggregation of voting interests and substantial shareholdings

- The substantial shareholding provisions of the Corporations Act should be modified in their application to REs of multiple schemes and associated REs.

Both IFSA and the Commonwealth Bank Group have suggested the application of these provisions causes significant problems due to the shareholdings in associated entities being aggregated for the purposes of determining substantial shareholdings. They have argued for some relief from these requirements for REs. ASIC is aware of this issue and has recently

23 Under section 111AF, ED securities are securities in relation to which a disclosure document has been lodged with ASIC under Chapter 6D, or securities issued pursuant to the disclosure document which have been held by 100 or more persons since the securities were issued.

released a discussion paper calling for submissions on whether relief is warranted and, if so, the form it should take.[24]

5.3.8 Scheme amalgamations and reconstructions

- Introduce arrangements to facilitate the amalgamation or reconstruction of registered schemes.

The Law Council of Australia has suggested that the lack of a clear statutory procedure for scheme amalgamations and reconstructions leads to uncertainty, as it may leave such arrangements open to legal challenge. The Law Council submission noted that the Financial System Inquiry nominated industry structure as a contributing factor to the cost of funds management in Australia, and argued that a clear statutory procedure for amalgamations and reconstructions may assist the industry in alleviating structural problems which add to costs.

Two models were put forward by the Law Council — one based on existing requirements applying to companies under Part 5.1 of the Corporations Act, and the other based on the successor fund transfer provisions of the SIS Act. Of these two, the Law Council favours the first model, which requires member consent. It is felt that member involvement in any reconstruction or amalgamation process would be important, and it is agreed that of the two models suggested, the first should be given further consideration.

5.3.9 Deregistration

- Amend subsection 601PA(2) to provide for voluntary deregistration in certain cases following a special rather than a unanimous resolution of a scheme's members.

Voluntary deregistration is permitted under subsection 601PA(2) if a scheme is not a managed investment scheme, has 20 or fewer members or is not required to be registered by paragraph 601ED(1)(b) or (c). In the two latter instances, all the members must agree to deregistration.

24 ASIC discussion paper, *Investment funds: takeover and substantial holding relief*, released 23 November 2001.

It has been argued[25] that a special resolution of members should be sufficient to allow for voluntary deregistration where a scheme (the original scheme) has been subdivided into a number of smaller schemes which are registered. The reasoning behind this is that, under the current provisions, the original scheme's constitution would require amendment as a result of the scheme's subdivision, and a special resolution only would be required to effect this.[26]

Following its amendment, the constitution of the original scheme would presumably no longer meet the requirements of sections 601GA and 601GB. ASIC would then have a discretion under paragraph 601PA(1)(b) to deregister the original scheme.

By amending subsection 601PA(2) so that a scheme may apply for voluntary deregistration upon the passing of a special resolution, it is argued that the more involved process leading to ASIC's deregistration would be short-circuited.

5.3.10 Forfeiture of partly paid units

- ASIC policy and Class Order 98/52 should be amended to remove the forfeited interest provisions.

Paragraph 601GA(1)(a) requires the constitution of a registered scheme to make adequate provision for the consideration that is to be paid to acquire an interest in the scheme.

ASIC Class Order 98/52 provides relief from certain policy requirements in PS 134 dealing specifically with paragraph 601GA(1)(a). Among other things, subparagraph (vi)A of the Class Order enables the RE of a registered listed scheme to decide the re-sale price for interests in the scheme which have been forfeited to the RE due to a failure to pay a call. The Class Order refers to the interests as having been forfeited to the RE on trust for the members and goes on to provide that the sale of these interests must comply (with the appropriate exceptions and modifications to terminology) with section 254Q of the Corporations Act.

25 Minter Ellison.
26 Paragraph 601GC(1)(a).

It has been argued that ASIC does not have the power under paragraph 601GA(1)(a) to formulate policy regarding the sale price of forfeited interests.[27]

The main thrust of the argument is that forfeited interests do not become the property of the RE to hold on trust for scheme members. Rather, the RE merely obtains a power of sale in relation to those interests so that their re-sale is a secondary sale involving the transfer of the interests from one member to another. The sale price applicable to such a transaction would be determined by the market at time of sale.

Consequently, if ASIC is to formulate policy regarding the sale price of forfeited interests, it would also need a statutory basis under which it can formulate policy concerning transfers from member to member and secondary sales. Paragraph 601GA(1)(a) does not provide this statutory basis.

ASIC has indicated that forfeiture of members' interests may be necessary for the effective management of a scheme.[28] However, it is concerned that the mechanism applicable to the forfeiture of these interests raises issues[29] that warrant further investigation.

ASIC has proposed that legislative reform would be desirable to establish an appropriate framework within which forfeiture of members' interests could be more appropriately regulated. Such reform might involve refinements to paragraphs 601FG(a)[30] and 601GA(1)(a).

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27 Freehills.

28 ASIC's supplementary submission dated 31 October 2001.

29 These issues include: disclosure obligations of the RE; ownership of the interest; the procedure applicable to the sale and distribution of the proceeds of the forfeited interests; and the general obligations of the RE at time of sale.

30 Paragraph 601FG(a) sets out the consideration for which the RE of a scheme may acquire and hold an interest in that scheme.

List of submissions

Association of Independent Retirees Inc
Australian Consumers' Association
Australian Managed Investments Association Ltd
Australian Securities and Investments Commission
Australian Stock Exchange Limited
Bray, Robert Ross
Commonwealth Bank Group
Constellation Capital Management Limited
CPA Australia and the Institute of Chartered Accountants in Australia
Dortkamp, Paul
Ernst & Young
Filmer, Rod
Freehills
Investment and Financial Services Association Limited
Kelly & Co Lawyers
Kernahan, Alan
KPMG
Law Council of Australia
Law Institute of Victoria
MAI Services Pty Limited
Minter Ellison
Munro, D.J.
President's Club Ltd
Routley, David
Toh, Eng Seng
Trust Company of Australia Limited
Trustee Corporations Association of Australia

Four confidential submissions were also received

Acronyms and abbreviations

ACA	Australian Consumers' Association
ACPA	Association of Compliance Professionals of Australia
ALRC	Australian Law Reform Commission
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
CASAC	Companies and Securities Advisory Committee
FSRA	*Financial Services Reform Act 2001*
ICCMF	Independent Compliance Committee Members' Forum
IDPS	Investor Directed Portfolio Services
IFSA	Investment and Financial Services Association Limited
MER	Management Expense Ratio
MIA	*Managed Investments Act 1998*
NTA	Net Tangible Assets
PJCCS	Parliamentary Joint Committee on Corporations and Securities
RE	Responsible Entity
SIS Act	*Superannuation Industry (Supervision) Act 1993*