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

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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

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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.

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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

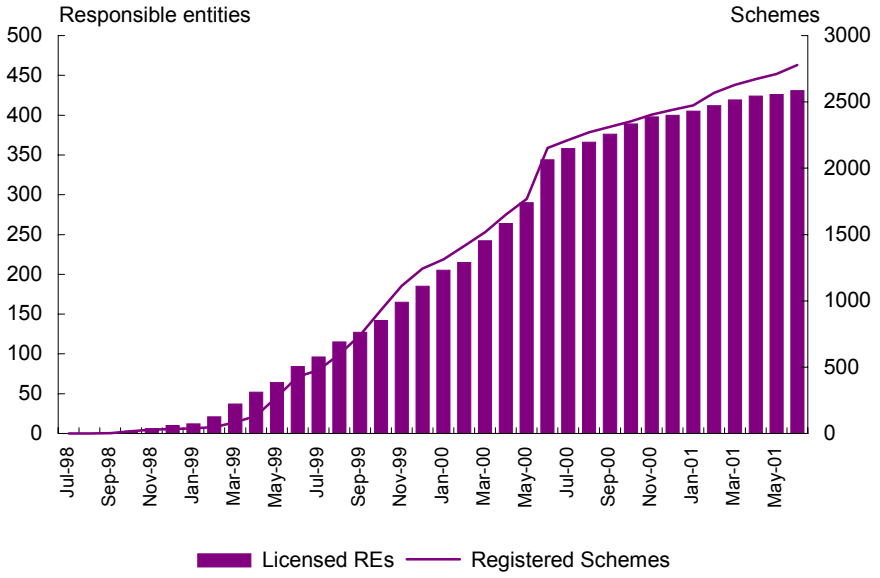

Table 1: Growth of managed investment industry

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

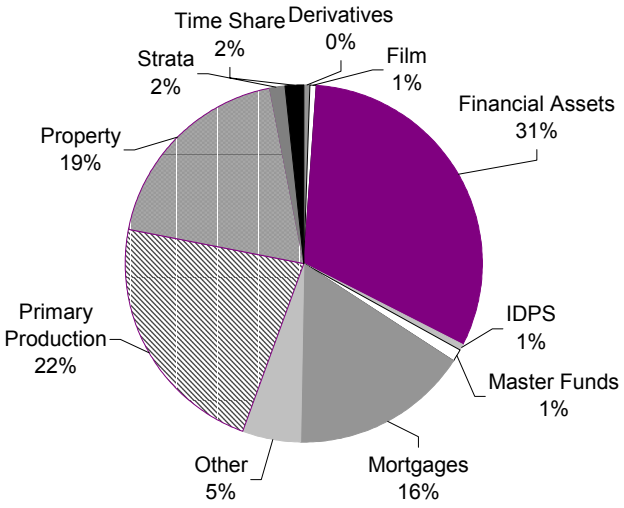

Table 2: Industry profile of licensed responsible entities as at 16 August 2001

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

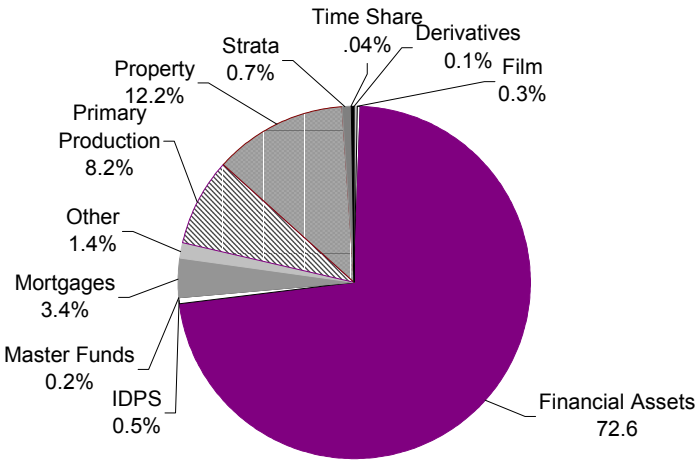

Table 3: Industry profile of registered schemes as at 16 August 2001

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.