The Law
Reform
Commission

Report No 65

The Companies
and Securities
Advisory Committee

Report

COLLECTIVE INVESTMENTS: OTHER PEOPLE'S MONEY

Volume 1

This Report
reflects the law
as at 1 June 1993

[It assumes that the *Corporate Law Reform Act 1992* (Cth) and the Corporate Law Reform (No 2) Bill 1992 [1993] (Cth) are both fully in operation.]

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ALRC Reference: ALRC 65

The Law Reform Commission was established by the *Law Reform Commission Act 1973* section 5 to review, modernise and simplify the law. It started operation in 1975. The office of the Commission is at 99 Elizabeth Street, Sydney, NSW, Australia (tel (02) 231 1733; fax (02) 223 1203).

The Companies and Securities Advisory Committee was established by the *Australian Securities Commission Act 1989* to monitor and advise on the operation of national scheme laws. It started operation in 1989. The office of the Committee is at Level 16, Westpac Plaza, 60 Margaret Street, Sydney, NSW, Australia (tel (02) 911 2950; fax (02) 911 2955).

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6. Financial controls on collective investment schemes

16. Transition to the new regime

Terms of reference

COMMONWEALTH OF AUSTRALIA

Law Reform Commission Act 1973
Australian Securities Commission Act 1989

1. I, Michael Duffy, Attorney-General of Australia noting:
   - the report of the Companies and Securities Law Review Committee to the Ministerial Council for Companies and Securities titled 'Prescribed Interests'; and
   - the need to ensure that there is a proper legal framework for prescribed interests and like collective investment schemes (collective investment schemes) that:
     — promotes commercial stability, and efficiency in capital raising and capital formation; and
     — provides an appropriate level of regulation that adequately and effectively protects the interest of investors,

refer to the Law Reform Commission for review and report under the *Law Reform Commission Act 1973* section 6:

(1) Whether the present legal framework for collective investment schemes provides for the most efficient and effective legal framework for the operation of the various kinds of such schemes and, in particular, whether a different operating structure should be provided for such schemes, including whether separate structures should apply to different kinds of schemes;

(2) Whether there is a proper level of regulation of the various kinds of collective investment schemes, and in particular:
   - whether different systems of regulation should be provided for different kinds of such schemes;
   - what disclosures should be made to the public;
   - whether scheme documents, such as trust deeds, can be simplified or standardised;
   - what should be the powers, duties and responsibilities of the persons who promote, manage, or supervise the operation of collective investment schemes, such as managers and trustees, including whether, and the extent to which, such duties and responsibilities should be codified;
   - whether any form of self-regulation would be appropriate;
   - what prudential requirements, if any, should be imposed on such persons as promoters, managers or trustees of such schemes, including requirements as to availability of capital;
   - whether a special framework for the liquidity of collective investment schemes, and for the secondary sale or trading of collective investment scheme interests, is desirable, including whether buy-back arrangements are appropriate and, if so, whether there is a need for particular buy-back provisions for particular kinds of such schemes; and

(3) any related matter;

and, under the *Australian Securities Commission Act 1989* section 148, request the Companies and Securities Advisory Committee to advise me about those matters.

2. In carrying out their functions, the Commission and the Committee are to consult the Australian Securities Commission, the Commonwealth Attorney-General's Department, relevant Commonwealth, State, and Territory authorities, the securities industry and any other person or body they think appropriate, having special regard to the Commonwealth's Access and Equity policy.

3. The report and advice should include draft legislation and an explanatory memorandum.

4. The report is to be delivered by 1 November 1992.

DATED: 24 May 1991

Michael Duffy
Attorney-General

Participants

Australian Law Reform Commission

The Division of the Commission for the purpose of this report comprised:

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Members
Jim Armitage (to 31 December 1992)[1]
Leigh Hall (to 31 December 1992)[2]
Stephen Mason
Mr Mason drafted the legislation in Volume 2.
Christopher Sidoti
Justice John von Doussa (from 17 September 1992)

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Mr Mark Burrows
Members
Mr Don Argus
Mr John Barner
Mr Reg Barrett
Professor Philip Brown
Mr Alan Cameron (from 1 January 1993)
Mr David Crawford
Mr Kevin Driscoll CBE
Mr William Gurry
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1. Mr Armitage and Mr Hall continued to work with the Review until the completion of this report.
2. Mr Hall is also a member of the Advisory Committee.
3. By agreement, the ALRC project team had primary responsibility for preparing this report.

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4. The recommendations, statements of opinion and conclusions in this report are those of the members of the ALRC and the Advisory Committee. They do not necessarily represent the views of consultants or of the organisations with which they are associated.

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Abbreviations

AARF	Australian Accounting Research Foundation
ABS	Australian Bureau of Statistics
AC	Appeal cases
ACLC	Australian Company Law Cases
ACN	Australian Company Number
ACSR	Australian Corporations and Securities Reports
Advisory Committee	Companies and Securities Advisory Committee
AFIC	Australian Financial Institutions Commission A body established under co-operative legislation to oversee the prudential regulation of SBFIs under State and Territory law
AGPS	Australian Government Publishing Service
ALRC	Australian Law Reform Commission
ALRC 16	Australian Law Reform Commission Report No 16 *Insurance Agents and Brokers* AGPS Canberra1980
ALRC 45	Australian Law Reform Commission Report No 45 *General Insolvency Inquiry* AGPS Canberra1988
ALRC 57	Australian Law Reform Commission Report No 57 *Multiculturalism and The Law* ALRC Sydney 1992
ALRC 59	ALRC & Advisory Committee Report No 59 *Collective investments: Superannuation* ALRC Sydney 1992
ALRC 60	Australian Law Reform Commission Report No 60 *Customs and excise* ALRC Sydney 1992
ASC	Australian Securities Commission
ASC Act	*Australian Securities Commission Act 1989* (Cth)
ASCPA & ICAA	Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia
ASX	Australian Stock Exchange Limited
ATO	Australian Taxation Office
BT	Bankers Trust Australia Limited
Campbell Committee Report	Committee of Inquiry into the Australian Financial System *Final Report* AGPS Canberra 1981 (Chairman: JK Campbell)
CLR	Commonwealth Law Reports
Corporations Law	The Corporations Law, set out in the *Corporations Act 1989* (Cth) s 82
CSLRC	Companies and Securities Law Review Committee established under the *Companies Act 1981* (Cth) (replaced by the Advisory Committee)
CSLRC DP	CSLRC Discussion Paper 6 *Prescribed Interests* Sydney 1987

CSLRC Report	CSLRC Report *Prescribed Interests* Sydney 1988
DP 50	ALRC & Advisory Committee Discussion Paper 50 *Collective investment schemes: Superannuation* ALRC Sydney 1992
DP 53	ALRC & Advisory Committee Discussion Paper 53 *Collective investment schemes* ALRC Sydney 1992
DTI	Deposit taking institution (principally banks, building societies and credit unions)
EC	European Community
Edwards Committee Report	Joint Select Committee on Corporations Legislation *Report* AGPS Canberra 1989 (Chairman: R Edwards)
FCA Act	*Federal Court of Australia Act 1976* (Cth)
FPAA	Financial Planning Association of Australia Limited
GDP	Gross domestic product
ICAA	Institute of Chartered Accountants in Australia
IFA	Investment Funds Association of Australia
IP 10	ALRC & Advisory Committee Issues Paper 10 *Collective investment schemes* ALRC Sydney 1991
IOSCO	International Organisation of Securities Commissions
IRC	Industrial Relations Commission
ISC	Insurance and Superannuation Commission
ISRO	Industry self regulating organisation
ITAA	*Income Tax Assessment Act 1936* (Cth)
Lavarch Report	House of Representatives Standing Committee on Legal and Constitutional Affairs *Corporate Practices and the Rights of Shareholders* AGPS Canberra 1991 (Chairman: M Lavarch)
LIA	*Life Insurance Act 1945* (Cth)
LIFA	Life Insurance Federation of Australia Incorporated
Martin Report	House of Representatives Standing Committee on Finance and Public Administration *A Pocket Full of Change - Banking and Deregulation* AGPS Canberra 1991 (Chairman: S Martin)
Martin Review Group Report	Review Group on the Australian Financial System *Report* AGPS Canberra 1984 (Chairman: VE Martin)
National Mutual	National Mutual Life Association of Australasia Limited
NCA	National Crime Authority
NCSC	National Companies and Securities Commission (replaced by the ASC)
NSWLR	New South Wales Law Reports
OECD	Organisation for Economic Co-operation and Development

Rae Report	Senate Select Committee on Securities and Exchange *Australian Securities Markets and their Regulation* AGPS Canberra 1974 (Chairman: PE Rae)
The Review	The ALRC and the Advisory Committee
RBA	Reserve Bank of Australia
SBFI	State based financial institution
TCA	Trustee Companies Association of Australia
TPA	*Trade Practices Act 1974* (Cth)
TPC	Trade Practices Commission
TPC Report	TPC Report *Superannuation and life insurance* 1992
UCITS	Undertakings for Collective Investment in Transferable Securities
UNSWLJ	University of New South Wales Law Journal
VFIC	Victorian Financial Institutions Commission

Summary of recommendations

Chapter 3 — What is a collective investment scheme?

1. The existing definition of 'prescribed interests' in the Corporations Law should be the basis of the definition of 'collective investment scheme' to which the regulatory regime recommended in this report should apply (para 3.5).

2. The expression 'prescribed interests' should be replaced by 'collective investment schemes' (para 3.5).

3. Common funds of statutory trustee companies that contain any money that is not a private client contribution should be regulated by the collective investment provisions of the Corporations Law (para 3.6).

4. The existing inclusions and exclusions of partnerships and limited partnerships from the scope of the prescribed interests provisions should be maintained under the collective investment provisions of the Corporations Law (para 3.7, 3.22).

5. The collective investment provisions of the Corporations Law should not apply to employee participation schemes (para 3.8).

6. The collective investment provisions of the Corporations Law should not apply to retirement village schemes (para 3.9).

7. Bonds issued by the Commonwealth or a State or Territory government, or by statutory authorities or corporations owned by them, should be excluded from the definition of 'collective investment scheme' in the Corporations Law (para 3.10).

8. Deposits with an Australian bank that are regarded by the RBA as part of the bank's banking business should be excluded from the definition of 'collective investment scheme' in the Corporations Law (para 3.11).

9. Deposits with building societies or credit unions regulated under the uniform local Financial Institutions Codes should be excluded from the definition of 'collective investment scheme' in the Corporations Law (para 3.12).

10. If, within eighteen months of the release of this report, the *Life Insurance Act 1945* (Cth) is not amended to impose on life insurers the same requirements as to the level and kind of disclosure as are imposed on offerors of collective investment schemes, investment linked life insurance policies should be brought within the definition of collective investment schemes and regulated under the Corporations Law (para 3.15).

11. Products offered by friendly societies should be exempted from the application of the collective investment provisions of the Corporations Law, provided the disclosure and marketing laws for friendly societies' investment products are, within a reasonable time, brought into line with those imposed on the offerors of collective investment schemes (para 3.16).

12. Superannuation schemes, ADFs, DAs and PSTs regulated under the Superannuation Industry (Supervision) Bill 1992 (Cth), when eventually enacted, should not be regulated by the collective investment provisions of the Corporations Law (para 3.17).

13. Arrangements declared as joint ventures by the ASC should not be regulated by the collective investment provisions of the Corporations Law (para 3.19).

14. Schemes where the only 'investors' are bodies corporate related to each other should not be regulated by the collective investment provisions of the Corporations Law (para 3.20).

15. Franchise arrangements should not be regulated by the collective investment provisions of the Corporations Law (para 3.21).

16. Shares, debentures and notes should not be regulated by the collective investment provisions of the Corporations Law (para 3.23, 3.24).

17. The regulation of investment companies should be referred to the Review for examination (para 3.25).

18. Schemes the minimum initial subscription for which is at least $500 000 should not be regulated by the collective investment provisions of the Corporations Law (para 3.28).

19. Schemes that are structured so that they cannot accept from all their investors more than $100 000 in total should not be regulated by the collective investment provisions of the Corporations Law (para 3.29).

20. The Corporations Law s 1084 should continue. The ASC should be able to modify, including by exclusion, the application of the collective investment provisions of the Corporations Law to schemes or classes of schemes (para 3.30).

21. The ASC should report annually to the Parliament on the number and kind of exemptions it granted during the year (para 3.30).

Chapter 4 — Establishing a collective investment scheme

22. The Corporations Law should not prescribe a particular legal form for collective investment schemes (para 4.2).

23. Obligations should be imposed on scheme operators directly by the Corporations Law, not by way of prescribed covenants. The covenants in the Corporations Law and regulations should be repealed (para 4.4).

24. A person dealing with the operator of a collective investment scheme should be entitled to assume that the scheme's constitution is being complied with (para 4.6).

25. There should be no requirement for the constituting document of a collective investment scheme to be approved by the ASC (para 4.8).

26. Each collective investment scheme should have to be registered by the ASC and given a unique registration number (para 4.9).

Chapter 5 — Disclosure

27. The prohibition on misleading and deceptive conduct imposed by the Corporations Law s 995 should specifically extend to all forms of advertising or disclosure material, including writing, films and other media, in respect of collective investment schemes (para 5.7).

28. The Corporations Law should provide that the front cover or front page of a prospectus of a collective investment scheme must display prominently the name of the scheme operator and the registration number of the scheme. Advertisements should also have to display that information (para 5.8).

29. The Corporations Law s 1022 should be modified, as it applies to collective investment schemes, to require prospectus issuers to provide information as to the nature of the risks of participating in the scheme, as well as the extent of the risks of participating in the scheme (para 5.11).

30. Prospectuses for collective investment schemes should have to include:

- a list of the kinds of investments authorised by the scheme's constitution
- how the operator's fees and charges are to be worked out
- if the prospectus suggests that another entity will or may assume a liability in relation to the scheme, for example, by way of guarantee — the circumstances in which the liability will arise
- the scheme's management expense ratio over the previous five years (or for the years the scheme has been in existence if it is less than five years old), that is, the ratio of total fees and expenses to the value of the assets in the scheme
- details of the scheme's internal dispute resolution procedures (para 5.14).

31. Limited offers of collective investment schemes should not automatically be exempted from the prospectus requirements of the Corporations Law (para 5.18).

32. Prospectuses issued for collective investment schemes should have to be lodged, but not registered, with the ASC (para 5.19).

33. The Corporate Law Reform Bill (No 2) 1992 [1993] (Cth) should provide that prospectuses issued for collective investment schemes have a life of 13 months (para 5.21).

34. The operator of a collective investment scheme should be required to give investors an annual report on scheme activities and set of audited accounts ((para 5.25).

35. Annual reports of collective investment schemes should have to include

- the unit price at the start and end of the reporting period, and the percentage change in price between the start and end of the period
- if the scheme is unlisted, an explanation of how the price of interests in the scheme is calculated
- the highest and lowest values of units during the last reporting period
- the size and nature of each investment that constitutes more than 5% of the funds of the scheme
- the investment policy of the scheme and its performance against that policy
- any significant changes to the scheme's state of affairs, including any material change in investment policy, in the reporting period
- details of any notices lodged with the ASC as part of the proposed enhanced disclosure regime
- the scheme's management expense ratio over the previous five years (or for the years the scheme has been in existence if it is less than five years old), that is, the ratio of total fees and expenses to the value of the assets in the scheme
- details of any purchase by the operator of existing or new interests in the scheme
- the procedure by which investors may apply for redemption of their interests, whether there is any obligation on the scheme operator to make redemption offers, and if so, the nature of that obligation
- details of the scheme's internal dispute resolution procedures
- details of any change of directors of the scheme operator (para 5.27)
- how many redemption or buy back opportunities were provided to investors in the previous 2 years and, where redemption requests or buy back acceptances were not met in full, to what extent they were able to be met (para 7.13, 7.21).

36. A scheme operator should be required to make its annual audited accounts available upon request to investors in schemes for which it is operator (para 5.28).

37. Operators of collective investment schemes should be required to prepare half yearly reports for their schemes, in accordance with the principles in the Corporations Law Reform Bill (No 2) 1992 [1993] (Cth). These report should be lodged with the ASC but need not be circulated to investors. They should have to include the following information for the previous six months:

- details of any change of directors of the scheme operator
- details of any purchase by the operator of existing or new interests in the scheme (para 5.31)

- how many redemption or buy back opportunities were provided and, where redemption requests or buy back acceptances were not met in full, to what extent they were able to be met (para 7.13, 7.21).

38. The Australian Accounting Standards Board should examine

- which accounting standards should apply to half yearly reports of collective investment schemes
- whether an accounting standard should be developed for collective investment schemes and the nature of any such standard (para 5.32).

39. The measures proposed in the Corporate Law Reform Bill (No 2) 1992 [1993] (Cth) for continuous disclosure by companies should also apply to listed and unlisted collective investment schemes (para 5.35).

Chapter 6 — Financial controls

40. The Corporations Law should not prescribe a minimum liquidity requirement for collective investment schemes (para 6.5).

41. Scheme operators should not be allowed to borrow, on behalf of the scheme, an amount more than 10% of the gross assets of the scheme unless the name of the scheme includes the word 'geared', or some other word approved by the ASC that indicates that it may have liabilities for borrowings, and the maximum permitted level of borrowing of the scheme is disclosed in any prospectus issued by the scheme operator (para 6.10).

42. The relevant assumptions and discount rates used in valuations of the assets of a collective investment scheme, and the other instructions given to valuers, should be disclosed to investors in the annual report (para 6.15).

43. The methods, for example, discounted cash flow, that valuers should be allowed to use when valuing assets of collective investment schemes should be the subject of a review by the ASC and industry representatives (para 6.15).

44. Scheme operators should be required to provide the ASC with an annual certificate prepared by an external auditor stating that, in the auditor's opinion, the operator is giving effect to the compliance measures imposed by the Commission as a condition of the operator's licence. A copy of the certificate should be included in the scheme's annual report (para 6.17).

45. External auditors of collective investment schemes should be required to report to the ASC where they have any reasonable grounds to suspect a breach of the law or of a scheme constitution (para 6.19).

46. The external auditor of a collective investment scheme should only be able to resign or be removed in accordance with the procedure under the Corporations Law s 329 (para 6.19).

Chapter 7 — Withdrawing from a collective investment scheme

47. The existing statutory buy back obligation imposed on management companies should be repealed (para 7.9).

48. A scheme operator should be able to purchase new interests in its scheme on the same basis as other investors (para 7.11).

49. A scheme operator should be allowed to purchase existing interests in its own scheme from investors at a price calculated in accordance with the scheme's constitution, but only after making a written offer to all investors. The offer must indicate the amount of money that the operator is prepared to spend in this offer. Purchases must be made on a pro rata basis where acceptances exceed the amount specified by the operator (para 7.12).

50. The annual and half yearly reports of a collective investment scheme should set out prescribed information about recent buy back offers (para 7.13).

51. Fully liquid schemes that provide redemption facilities must make the facility available to all investors on the same terms (para 7.17).

52. Operators of less than fully liquid schemes should only be allowed to provide redemption facilities on the following basis:

- the offer must be made to all investors in the same terms
- the operator must lodge notice of the redemption offer with the ASC
- the operator must meet redemption requests only from the liquid assets of the scheme that are on hand at the close of the offer period
- redemption requests must be paid out at a price calculated in accordance with the scheme's constitution
- if the liquid assets are insufficient to meet all redemption requests, the operator must redeem on a pro rata basis (para 7.21).

53. The annual and half yearly reports of a collective investment scheme should set out prescribed information about recent redemptions (para 7.21).

Chapter 8 — Termination, winding up and voluntary administration of a scheme

54. The exclusion of the rule against perpetuities in the Corporations Law should be extended to all collective investment schemes (para 8.3).

55. A provision in the constitution of a collective investment scheme that would terminate the scheme if the scheme operator is removed should be ineffective (para 8.4).

56. Investors in a collective investment scheme should be able to terminate a collective investment scheme, for any reason, by the vote of the holders of more than 50% of the value of the interests in the scheme (other than interests held by the scheme operator or its associates) (para 8.5).

57. Investors should be able to terminate an insolvent scheme by special resolution of three quarters of the investors (other than the scheme operator and its associates) voting on the resolution, provided that an external auditor has certified that the scheme is insolvent (para 8.6).

58. The court should have the power to terminate a scheme whenever it is of the opinion that it would be just and equitable to do so (para 8.7).

59. The court should have the power to terminate an insolvent scheme on application by a creditor, the scheme operator, a director of the scheme operator, a liquidator or provisional liquidator of the scheme operator or the ASC. An applicant should first be required to obtain leave of the court by establishing a prima facie case that the scheme is insolvent (para 8.8).

60. If the purpose for which a scheme was established has been accomplished, or is no longer capable of being achieved, the scheme operator should be permitted to advise investors and the ASC that the scheme will be terminated in 28 days unless the operator receives a requisition from investors or the ASC for a meeting of investors to consider a resolution that the scheme not be terminated but that the constitution of the scheme be amended appropriately (para 8.9).

61. It should be an offence for a scheme operator to continue a scheme, including by taking new contributions, without a court order if the scheme has terminated (para 8.10).

62. Matters that are common to the winding up of all collective investment schemes should be included in the Corporations Law (para 8.11).

63. The court should have a wide power to give directions in relation to the winding up of a scheme (para 8.11).

64. A registered liquidator should be appointed, either by the court or by the scheme operator, to a scheme that has been terminated. The liquidator should be able to continue the business of the scheme if this is for the better winding up of the scheme (para 8.12).

65. The voluntary administration procedure in the Corporations Law Pt 5.3A should be adapted to permit an administrator to be appointed to deal with the affairs of an insolvent scheme (para 8.13).

66. The liquidator of a scheme operator should not become the liquidator of the operator's schemes unless the court so orders (para 8.14).

Chapter 9 — Compliance

67. At least half of the board of the operator of a collective investment scheme should be non-executive directors. A director is non-executive if he or she is not, or has not been during the previous three years, an employee or executive officer of the scheme operator or of an entity related to the operator and does not hold any shares in the operator or an entity related to the operator (para 9.10).

68. The Corporations Law should provide that if the operator of a collective investment scheme holds property of the scheme it will do so on trust for the scheme investors (para 9.14).

69. The Corporations Law should provide that if a scheme operator holds scheme assets it must identify them in such a way that they are clearly property of a particular collective investment scheme (para 9.15).

70. Application forms for interests in a collective investment scheme should direct that cheques be drawn in favour of the scheme operator on account of the particular scheme (para 9.15).

Chapter 10 — The scheme operator

71. Only companies incorporated under the Corporations Law may apply for a scheme operators licence (para 10.2).

72. Responsibility for a collective investment scheme should lie with the operator. The Corporations Law should state clearly a set of obligations for scheme operators and their officers which may not be modified or excluded by a scheme's constitution (para 10.6).

73. The Corporations Law should impose an obligation on the operator of a collective investment scheme to act honestly in respect of the scheme (para 10.7).

74. The Corporations Law should impose an obligation on the operator of a collective investment scheme to exercise its powers and perform its duties as operator in the best interests of investors rather than in its own, or anyone else's, interest, if that interest is not identical to the interests of the scheme investors (para 10.8).

75. It should be an offence for an operator to make payments out of the scheme property on account of expenses or charges, either for itself or for anyone else, except in accordance with the scheme's constitution (para 10.9).

76. A scheme operator should not be able to recover from scheme assets the cost of hiring an investment manager or an investment adviser (para 10.10).

77. The Corporations Law should impose an obligation on operators of schemes in which the investors do not retain title to the scheme's assets, to keep the scheme's assets separate from their own assets (para 10.11).

78. The Corporations Law should impose on scheme operators an obligation to treat the holders of interests of the same class equally and to treat the holders of interests of different classes fairly (para 10.12).

79. The Corporations Law should provide that a scheme operator must not make improper use of information that it gets as operator of a particular scheme, or of its position as operator, to gain an advantage for itself or for any other person or to cause detriment to the investors in the scheme (para 10.13).

80. The Corporations Law should provide that where there is a conflict between the duty an officer of the operator owes to the operator and a duty he or she owes to investors, the duty to investors should prevail. Officers should be given statutory protection from claims by the operator or its shareholders arising from any loss they suffered in consequence of officers complying with their paramount duties to investors (para 10.17).

81. The Corporations Law should impose on officers of scheme operators the duty to act honestly in all matters relating to the scheme (para 10.18).

82. The Corporations Law should impose on officers of scheme operators the duty to exercise their powers and discharge their duties in respect of the scheme with the degree of care and diligence that a reasonable person in a like position would exercise in similar circumstances (para 10.19).

83. The Corporations Law should impose on officers of scheme operators the duty to act in the interests of investors and not in the interest of themselves, the operator or any other person where those interests are not identical (para 10.20).

84. The Corporations Law should prohibit an officer of a scheme operator from making improper use of information gained by virtue of his or her position as officer, to gain an advantage for himself or herself or for another person, or to cause detriment to the investors in the scheme (para 10.21).

85. The Corporations Law should impose on officers of scheme operators the duty to take all reasonable steps to ensure that the operator complies with all its obligations (para 10.22).

86. The principles in the Corporations Law Part 3.2A, adapted for collective investment schemes, should regulate transactions where a scheme operator, its associates, or any other related party could receive a financial benefit from dealings involving scheme assets. Various transactions should be exempted. A non-exempt related party transaction should be permitted only if it is agreed to by a prior resolution of a simple majority of disinterested investors, provided they have been fully informed about the transaction and its likely impact upon the scheme (para 10.25).

87. The Corporations Law should prohibit any person from accepting any payment or other benefit in relation to retirement from office of the operator or any of its officers, including employees, unless it has been approved by the votes of the holders of more than 50% of the value of the voting interests of the scheme (para 10.26).

88. Scheme operators should be required to have at all times capital equal to 5% of the value of the assets of all schemes operated by the operator, subject to a minimum of $100 000 and a maximum of $5m. It should be an offence for a scheme operator to have, for a period of 14 consecutive days, a capital level below that required (para 10.31).

89. The law should prohibit scheme operators from guaranteeing or providing any indemnity in respect of loans, whether the loan is to another member of the corporate group or not (para 10.32).

90. Scheme operators should be required to have a scheme operators licence, issued by the ASC (para 10.35, 10.36).

91. The ASC should keep a register of licensed operators of collective investment schemes (para 10.41).

92. The ASC should have to consider whether the compliance measures summarised in an application for a scheme operators licence are reasonably likely to detect in advance and prevent contraventions of the law or of the scheme's constitution (para 10.43).

93. If the ASC considers that the measures disclosed in the summary, or that are otherwise known to it, are not reasonably likely to detect in advance and prevent contraventions of the law or of the scheme's constitution, it may refuse to grant a licence or grant a licence subject to conditions relating to compliance measures (para 10.43).

94. The law should set out a non-exhaustive list of compliance factors that the ASC must take into account in considering an applications for a scheme operators licence (para 10.44).

95. In considering whether proposed compliance measures are reasonably likely to detect in advance and prevent a potential breach of the law, the ASC should take into account who will have the legal title to the scheme's assets and, if an external custodian is to have legal title, the arrangements between the proposed custodian and the operator (para 10.45).

96. If the ASC does not refuse to grant a scheme operators licence, it must notify the applicant that it will issue a licence subject to the conditions contained in the notice. The conditions must relate to compliance (para 10.46).

97. The directors of the applicant for a scheme operators licence must, before the licence is granted, certify that they have examined the conditions of the licence, that they are satisfied that the compliance measures specified in the conditions are

reasonably likely to detect in advance and prevent contraventions of the law or of the scheme's constitution and that the applicant is able to give effect to them if the licence is granted (para 10.47).

98. A scheme operator must comply with the conditions imposed on its licence. Failure to do so should be a contravention of the Corporations Law but not an offence (para 10.48).

99. The ASC may change the conditions of an operator's licence at the request of the operator or on its own initiative (para 10.49).

100. The Corporations Law should provide that the ASC must reject an application for a scheme operators licence if the applicant is externally administered or one of its officers is an insolvent under administration (para 10.52).

101. The Corporations Law should provide that the ASC must refuse to grant a scheme operators licence if any officer of the applicant has been convicted of serious fraud in the past five years, has not been released from prison for more than five years after serving a sentence for a conviction for serious fraud or is otherwise prohibited from managing a corporation (para 10.53).

102. An applicant for a scheme operators licence should be required to disclose to the ASC in its application any conviction for serious fraud and the circumstances in which it arose and any civil penalty for an act of dishonesty to which it has been subjected (para 10.53, 10.54).

103. The Corporations Law should provide that the ASC must refuse to grant a scheme operators licence if any officer of the applicant has been subject to a civil penalty for an act of dishonesty in the five years before the application is made or is otherwise prohibited from managing a company (para 10.54).

104. The Corporations Law should provide that the ASC must refuse to grant a scheme operators licence unless at least half of the applicant's directors are non-executive (para 10.55).

105. The Corporations Law should provide that a company may not retire as the operator of a collective investment scheme until a replacement operator has been appointed (para 10.57).

Chapter 11 — The investor

106. The operator of a collective investment scheme should be required to maintain a register of investors (para 11.3).

107. Investors in a collective investment scheme should have access to material contracts referred to in a scheme prospectus. The ASC should, however, have power to permit the scheme operator to deny access where appropriate (para 11.3).

108. Investors in a collective investment scheme should have a statutory right to apply to the court for an order permitting a legal practitioner or auditor to inspect the books of the scheme (para 11.4).

109. Scheme operators should be required to issue certificates to purchasers of interests within two months after the allotment of those interests unless the scheme constitution otherwise provides (para 11.5).

110. The half yearly and annual reports of a collective investment scheme should include details of changes of directors of the scheme operator (para 11.9).

111. The operator of a listed collective investment scheme should have to keep a register of substantial interest holdings (para 11.12).

112. The operator of a listed collective investment scheme should include in the annual report of the scheme the total number of voting interests in the scheme as at the date of the report. An investor should have to notify the operator within 14 days of receiving the report if, on the basis of information in that report,

- unless previously notified, its entitlement has increased to 30% or more of the voting interests in the scheme
- its voting entitlement has changed by at least 5% since it last notified the operator of its substantial holding or
- it is no longer entitled to 30% of the voting interests (para 11.12).

113. A scheme operator should include on the register of investors details of its entitlement to interests if it exceeds 30% of the total issued interests. If its entitlement changes by 5% or falls below 30% of total issued interests, the operator should have to amend the register (para 11.12).

114. The Corporations Law should contain provisions for mergers of collective investment schemes, based on the Corporations Law Pt 5.1 as it applies to the amalgamation of companies (para 11.14).

115. A scheme operator should not be able to transfer its right to operate a scheme without the approval of investors unless pursuant to the court appointment of a replacement scheme operator (para 11.15).

116. Where a temporary scheme operator considers that the scheme should continue and the court agrees, the temporary scheme operator should be obliged to, and the investors may, call a meeting of investors to appoint a temporary scheme operator (para 11.16).

117. Investors in a collective investment scheme should be able to remove the scheme operator by the majority vote of the holders of more than 50% of the value of the interests in the scheme. If the investors do not agree on a replacement operator, the outgoing operator should be required to apply to the court for the appointment of a temporary scheme operator. An investor or the ASC should also be able to apply to the court for the appointment of a temporary scheme operator (para 11.17).

118. Investors in a collective investment scheme should have no power to give directions to the scheme operator (para 11.18).

119. Where a scheme operator proposes an amendment to the scheme's constitution, it should give investors and the ASC notice of the proposed amendment and inform them of

- details of the amendment sought
- the reasons for the proposed amendment.

It must call a meeting of investors to approve the amendment unless it considers that the proposed amendment is minor and will not adversely affect the interests of investors. If the operator does not call a meeting, the investors or the ASC may call a meeting of investors to vote on the amendment (para 11.21).

120. An investor in a collective investment scheme may propose an amendment to the scheme constitution, with the agreement of the scheme operator. The proposed amendment must be voted on by investors (para 11.22).

121. The voting majority for investor approval of an amendment to the scheme constitution should be 75% by value or more of at least 25% of the value of interests held by persons entitled to vote (para 11.21, 11.22).

122. Investors in a collective investment scheme should be able to call a meeting for the purpose of exercising the powers they have in respect of the scheme (para 11.23).

123. Any interests in the scheme held by the scheme operator or its associates should be non-voting interests except where those interests are held on bare trust and the operator or the associate does not have any discretion in determining how to vote. Non-voting interests should not be counted when determining the total number of interests in the scheme for the purpose of calculating the percentage of investors voting (para 11.26).

124. Investors in a collective investment scheme should be permitted to vote on a resolution in person, by post or by proxy (para 11.27).

125. There should be a comprehensive review of takeovers of collective investment schemes. The review should include the need for provisions permitting compulsory acquisition of minority interests (para 11.30).

126. The Corporations Law should provide a right for investors in collective investment schemes to apply to the court for an order under a provision based on the Corporations Law s 260 (oppression remedy) (para 11.33).

127. Scheme operators should be required to

- maintain an internal dispute resolution procedure to deal with investor enquiries and complaints

- include in each prospectus and annual report details of the scheme's internal dispute resolution procedure (para 11.35).

128. The Corporations Law should limit the liability of investors in collective investment schemes that are trusts to the unpaid amount, if any, of their investment in the scheme (para 11.37).

Chapter 12 — No compulsory third party needed

129. The Corporations Law should not require the operator of a collective investment scheme to involve another entity in the operation of the scheme (para 12.12).

Chapter 13 — Intermediaries

130. The prohibition in the Corporations Law on dealing in securities without a dealers licence should not be infringed merely because the licensed operator of a collective investment scheme issues, buys or redeems interests in its own scheme. Nor should the prohibition on advising on securities without a dealers licence or investment advisers licence be infringed merely because the operator of a scheme gives advice about interests in a scheme of which it is the operator (para 13.4).

131. If a scheme operator authorises a representative, the procedures and requirements and, particularly, the liability, for the representative should be the same, as nearly as possible, as for representatives of licensed dealers (para 13.4).

132. Specific educational qualifications and experience necessary to gain a dealers licence under which the licensee will be allowed to advise persons about securities or an investment advisers licence should be prescribed. This should be done as soon as possible (para 13.6).

133. The Corporations Law should be amended to prohibit a securities adviser or the holder of a scheme operators licence from making a securities recommendation to a client that the client may reasonably be expected to rely on unless

- the adviser or operator has made reasonable inquiries about, and other reasonable investigations of, the client's investment objectives, financial situation and needs and
- the recommendation is based on the results of those inquiries and investigations (para 13.10).

134. The Corporations Law should require that, if a securities adviser or the holder of a scheme operators licence makes a securities recommendation to a client who can reasonably be expected to rely on it, it should have to give the client a written statement of the recommendation (para 13.11).

135. The Corporations Law should prohibit a dealer or investment adviser from holding himself or herself out as independent, whether by describing himself or herself as independent or otherwise, if he or she has entered into any arrangement

under which he or she will, as a result of a recommendation to a client, receive a benefit other than from the client on account of buying or selling any securities. 'Benefit' should include all benefits, not just commissions (para 13.16).

136. A dealer or investment adviser that is a body corporate must not hold itself out as independent if a body in whose securities it may lawfully deal or about whose securities it may lawfully advise other persons or publish reports is in a position to control it (para 13.16).

137. The Corporations Law should be amended to require securities advisers and scheme operators, when they make a securities recommendation, to disclose to their clients how much of the client's investment will be deducted for fees, commissions and other charges. The amount of each fee and charge, and what it was for, should be disclosed in writing before the transaction recommended, or one substantially like it, is carried out. Failure to disclose should be an offence (para 13.19).

138. The *Life Insurance Act 1945* (Cth) should be amended to impose on persons selling investment linked life insurance policies requirements that reflect the recommendations made in respect of intermediaries regulated under the Corporations Law (recommendations 133 — 137) (para 13.23).

139. No system for licensing life agents should be introduced (para 13.27).

Chapter 14 — The regulator

140. Collective investment schemes as defined in chapter 3 should be regulated by the ASC as part of the national corporations scheme laws (para 14.3).

141. The Commonwealth should retain primary responsibility for regulating participants in the collective investments industry (para 14.4).

142. In regulating collective investment schemes, the ASC should have available all its existing information gathering powers under the Corporations Law and the *Australian Securities Commission Act 1989* (Cth) (para 14.7).

143. To enhance its existing surveillance powers, the ASC should have powers, exercisable whether or not a contravention is suspected, to

- gain access to, and within, premises to search for and examine relevant books
- bring devices upon premises to assist in such search or examination
- check and operate computers or other devices already upon the premises to obtain relevant information
- secure relevant books found during a surveillance visit
- require persons to assist its surveillance audit (para 14.9).

144. The ASC should have power to require a person within Australia to authorise the Commission to obtain documents or any other record of information directly from overseas parties (para 14.10).

145. The existing search warrant provisions should be amended to permit warrants to be obtained by facsimile or telephone if it is impractical to apply for a warrant in person and to permit a person executing a warrant to leave the premises temporarily without the warrant thereby being discharged (para 14.11).

146. The ASC should be able to apply to a court for the arrest of a person who is absconding from Australia or improperly dealing with books to avoid his or her obligations in connection with the winding up of a collective investment scheme (para 14.13).

147. The directors and other officers of scheme operators and any other persons involved in the compliance activities of collective investment schemes should be given statutory qualified privilege in respect of any information volunteered to the ASC (para 14.15).

148. The court should have power, exercisable upon the application of the ASC, a director of the scheme operator or an investor, to direct a scheme operator to comply with the scheme constitution (para 14.19).

149. The court should have power, upon an application by the ASC, an investor or the scheme operator or any of its directors to appoint a person to act as the temporary scheme operator (para 14.20).

150. The ASC should be entitled act as a representative party pursuant to the Federal Court class action rules (para 14.22).

151. The ASC should have a specific power to provide private litigants with any relevant books it has in its possession, in addition to those related to an oral examination (para 14.22).

152. The ASC should have a power similar to that available to the Trade Practices Commission under the *Trade Practices Act 1974* (Cth) s 87B to enter into enforceable undertakings with a scheme operator (para 14.24).

153. The ASC should have power to call investors' meetings and propose resolutions (para 14.26).

154. The ASC should be able to attend and speak at any meeting of the investors in a collective investment scheme (para 14.27).

155. A scheme operator should have to advise the ASC promptly of any breach of its licence conditions (para 14.28).

156. The ASC should have power, without a hearing, to revoke the licence of a scheme operator if it

- becomes an externally administered body corporate
- ceases to carry on business
- requests the ASC to revoke its licence (para 14.29).

157. The ASC should have power to revoke a scheme operators licence, outright or in respect of one or more schemes, subject to providing an opportunity for a hearing, if it is satisfied that there is a significant risk that the operator will contravene or fail to comply with the Corporations Law in relation to a substantial matter (para 14.30).

158. The ASC should, on giving a notice revoking a scheme operators licence, apply to the court for the appointment of a temporary scheme operator, unless an eligible replacement scheme operator has already been properly appointed or the scheme has been terminated (para 14.31).

159. Any written notice to a scheme operator, or any other affected person, of a decision or determination by the ASC should be required to include a statement of any rights to apply for a review of the decision or determination by the Administrative Appeals Tribunal (para 14.32).

Chapter 15 — Offences and remedies

160. The fault element of each contravention of the Corporations Law should be expressly stated in that law (para 15.2).

161. For a number of contraventions there should be no fault element (para 15.3).

162. The defence that the defendant was taking all reasonable measures to prevent contravention of the relevant kind should apply in respect of most contraventions (para 15.5).

163. The penalty notice provision of the Corporations Law (s 1313) should be available for appropriate offences (para 15.7).

164. The civil penalty regime (Corporations Law Pt 9.4B) should apply to contraventions of duties (analogous to the duties set out in the Corporations Law s 232) that directors and other executive officers of a scheme operator owe to investors (para 15.9).

165. The civil penalty regime should not apply to a scheme operator in respect of a breach by it of its obligations to investors (para 15.11).

166. All the acts of a body corporate's officers and agents that are within their actual or apparent authority should be attributed to the corporation except where the servant or agent acted only for his or her own benefit and where the body corporate took reasonable measures to prevent its servants or agents doing the act (para 15.16).

167. The state of mind of, or standard of care exercised by, the person who does an act that, under the previous recommendation, is attributed to the body corporate should also be attributed to the body (para 15.17).

168. The state of mind of, or standard of care exercised by, the person who, within his or her actual or apparent authority, authorises or directs an act to be done should be attributed to the body as well (para 15.17).

169. Attribution rules similar to those in recommendations 166 — 168 should apply in cases where there is a need to determine when a scheme operator has knowledge of a matter (para 15.18).

Chapter 16 — Transitionals

170. Subject to the exceptions indicated in chapter 16, all schemes that are to continue after the commencement of the collective investment provisions of the Corporations Law should be required to comply with the requirements of those provisions (para 16.2).

171. Existing schemes should have two years in which to convert from the existing regime to the new regime. The ASC should be able to extend this period if appropriate (para 16.3).

172. The consent of the party that does not apply to be licensed as the scheme operator should have to be attached to the licence application if the application is made within 18 months after the legislation implementing the Review's recommendations is implemented. After that time, the management company should be able to apply without the trustee's consent (para 16.3).

173. The law should be amended to ensure that if, during the transition to the new regime, assets of a prescribed interest scheme are transferred no liability to stamp duty or to capital gains tax is incurred (para 16.3).

174. The rules for terminating and winding up a scheme should not apply until the scheme is registered and the operator licensed (para 16.3).

175. All disclosure requirements that do not depend on the existence of a scheme number, such as the enhanced disclosure recommendations, should apply from the commencement of the amendments to the Corporations Law recommended in this report (para 16.4).

176. Schemes should not have to comply with the financial controls recommended in chapter 6 until they are registered under the new regime. The requirements relating to audits should, however, apply as soon as the new provisions are implemented (para 16.5).

177. The Review's recommendations about procedures for leaving a collective investment scheme should be implemented at the earliest opportunity. They can be implemented independently of the other recommendations in this report (para 16.6).

178. The obligations to be imposed on scheme operators and their officers should not be imposed until the scheme is registered and a scheme operator licensed (para 16.7).

179. The recommended investors' rights of access to information about the scheme should be available as soon as the amending legislation commences (para 16.8).

180. The obligations the Review recommends should be imposed on scheme operators in respect of annual and other reports should be imposed on managers of prescribed interest schemes for which there is an approved deed as soon as possible after the amending legislation is enacted (para 16.8).

181. After commencement of the recommended amendments but before the scheme is registered and an operator licensed, investors should have the same right to dismiss the trustee or management company as they would have under the new regime to dismiss the operator (para 16.9).

182. The mechanism for amending the constitution of a prescribed interest scheme should not be changed until the scheme is registered (para 16.9).

183. The recommended right of investors to apply to the court for relief on the grounds of oppression should be available to investors in all schemes on the commencement of the amending legislation (para 16.10).

184. The recommended controls on intermediaries should apply as soon as the amending legislation commences (para 16.11).

185. As soon as the amending legislation commences, the ASC should be able to exercise, in relation to both the trustees and managers of prescribed interest schemes, all the powers it will have, including powers to conduct audit surveillances, in respect of scheme operators (para 16.12).

1. Introduction

The reference

1.1 On 24 May 1991 the federal Attorney-General, Mr Michael Duffy MP, asked the Australian Law Reform Commission and the Companies and Securities Advisory Committee (the Review) to carry out a thorough review of the regulatory framework for prescribed interests and 'like collective investment schemes'. The terms of reference are set out at the front of this report. This report is a joint report of the Commission and the Advisory Committee.

Background to the reference

Prescribed interests and like collective investment schemes

1.2 The term 'collective investments' covers a wide variety of investment schemes. Most involve a number of investors handing over their money or some assets to a professional manager who manages the total fund or collection of assets to produce a return which is shared by investors. A common form of collective investment is the unit trust, but there are many others. Most are subject to regulation under the Corporations Law as 'prescribed interests'.

Collective investment schemes and the economy

1.3 Collective investment schemes are a major source of investment funds in Australia. There is an enormous variety of such schemes, from the largest commercial property and cash management trusts through to yabbie farm schemes, pine forest schemes, jojoba bean plantation schemes and racehorse syndicates. During the 1980s these schemes grew rapidly, partly as a result of deregulation in the financial sector. Investments in unit trusts alone grew from less than $2 billion in 1980 to over $38 billion in 1992. The fastest growing unit trusts were cash management trusts and, until recently, property trusts. Increasingly the funds in these schemes come from persons investing their superannuation lump sums and from superannuation schemes seeking better rates of return than those offered by banks. The amount of money invested in collective investment schemes will continue to increase now that superannuation is compulsory for most workers.

Need for investor confidence

1.4 While many investors are keenly aware of what they are doing, others do not have the experience or expertise to appreciate fully the risks associated with investing. Many investors in these schemes choose them because they enable investors to pass responsibility for the day-to-day management of their savings to someone else. These investors rely on the law, not their own expertise and ability, to provide their savings with appropriate protection. The ability of collective investment schemes to continue to accumulate the savings of Australians and channel them into investment will depend heavily on investor confidence in the regulatory regime for these schemes.

Investor confidence and decline in commercial property values

1.5 At the end of the 1980s there was a rapid and unsustainable rise in Australian asset prices, particularly for commercial property. This was accompanied by an unprecedented increase in the size of the unlisted property trust market. Between 1988 and 1990 unlisted property trust assets swelled by 62% from $5.5 billion to $8.9 billion. The collapse of the Estate Mortgage trusts in particular focused attention on the difficulties facing unlisted property trusts. Within a year asset values had fallen by almost $2 billion (or 22%) to $6.9 billion, resulting in quite spectacular capital losses by investors in these property trusts and triggering the virtual closure of all unlisted property trusts except those whose management companies were controlled by banks. The opportunity for the remaining unlisted property trusts to increase their market share was short-lived, however. The loss of confidence by investors meant that redemption requests continued to outstrip applications for new units. After the promoters of the remaining property trusts and their parent banks approached the federal Government, the federal Attorney-General and the federal Treasurer announced, on 23 July 1991, a one year freeze on redemptions from unlisted property trusts.[1] This freeze did not stop the collapse in asset prices. It merely stopped the collapse of schemes as a result of the panic withdrawal of funds. For example, in the first nine months following the imposition of the freeze on redemptions, the value of unlisted property trust assets fell a further $2.4 billion, from $6.9 billion to $4.5 billion, making a total loss since 1990 of $4.4 billion or almost half their value.

Calls for reform

1.6 The need for a comprehensive review of collective investment schemes has been acknowledged in Australia for almost 20 years. In 1974, the Senate Select Committee on Securities and Exchange (the Rae Committee) called for reform of the regulation of securities markets to enhance their capacity to mobilise investment funds.[2] In 1981 the Committee of Inquiry into the Australian Financial System (the Campbell Committee) pointed to the need for comprehensive reform, suggesting that separate legislation for collective investment schemes be considered.[3] In 1988 the Companies and Securities Law Review Committee (CSLRC) examined the regulation of prescribed interests under the then Companies Codes.[4] Finally, in 1990, the National Companies and Securities Commission (NCSC) Unit Trusts Task Force recommended a full-scale review of the regulatory framework for prescribed interests.

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1. See *Corporations Law (Unlisted Property Trusts) Act 1991* (Cth).
2. Senate Select Committee on Securities and Exchange *Australian Securities Markets and their Regulation* AGPS Canberra 1974.
3. Committee of Inquiry into the Australian Financial System *Final Report* AGPS Canberra 1981, para 21.171.
4. CSLRC Report.

A thorough review required

1.7 The reviews of prescribed interest schemes undertaken to date, such as the ASC reviews of property trusts and trustee common funds and the 1990 NCSC review of unit trusts, were all conducted on the basis that the existing regulatory structure was not to be replaced. The terms of reference from the Attorney-General require the Review to consider 'whether the present legal framework for collective investment schemes provides for the most efficient and effective legal framework' for those schemes. The Review, therefore, has not taken the existing legal framework as given. It is not enough merely to try to fashion further *ad hoc* changes to add to those made after the previous reviews. Instead, the Review has taken the opportunity presented to it by the Attorney-General to conduct a thorough and fundamental review of the appropriate regulatory framework for collective investment schemes.

The Review's work

A joint report

1.8 The Attorney-General's reference was given jointly to the ALRC and the Advisory Committee. By arrangement between the two bodies, the ALRC assumed administrative responsibility for the work. Officers of both the ALRC and the Advisory Committee prepared the report.

Issues paper (IP 10)

1.9 In September 1991 the Review published a comprehensive issues paper (ALRC IP 10, 1991). That paper identified the scope of the collective investments industry and discussed the importance of the industry for both national retirement incomes policies and capital formation in Australia. It set out the issues, so far as the Review saw them then, and called for submissions. The Review received over 40 submissions in response to this paper.

Superannuation — interim report

1.10 ***Request for interim report.*** In September 1991, just before IP 10 was published, the Attorney-General wrote to the Review asking for an urgent interim report on superannuation issues. Specifically, he asked that the report

> traverse the regulation of superannuation investments products under the Corporations Law. As part of that report it would also be desirable, where appropriate, to consider the regulatory arrangements applying to comparable investment products which are not currently regulated by the Corporations Law.

This request was a result of developments in the Commonwealth's retirement incomes policy, which aims to generate long term savings by individuals to provide a capital base and thus increase their level of retirement income. Superannuation is also becoming increasingly important in the Australian economy. Total superannuation assets have quadrupled in the last decade to $139 billion and is likely to more than double again by the turn of the century. The

Review interrupted its work on the broader reference and focused on superannuation. In January 1992, the Review published a discussion paper (ALRC DP 50, 1992) setting out preliminary proposals for the regulation of superannuation. The Review received 111 submissions from a wide range of individuals and organisations.

1.11 ***Interim report (ALRC 59).*** The Review published its report, *Collective investments: superannuation* (ALRC 59, 1992), in April 1992. It covered most major issues associated with the regulation of superannuation schemes, including

- the constitutional power to regulate superannuation
- the policy implications of the changed nature of superannuation from a voluntary to a compulsory system
- standards of probity for those who administer superannuation schemes
- duties of superannuation scheme trustees
- disclosure to members and prospective members of superannuation schemes and to the regulator
- investment controls that should be imposed on superannuation schemes
- the role and powers of the regulator
- the relationship between superannuation schemes and their members, including the need for inexpensive, non-judicial resolution of disputes
- problems concerning surpluses and reserves.

Announcements by the federal Treasurer, Mr John Dawkins, in June and October 1992 indicated that the Government accepted most of the recommendations in the report. Legislation to implement many of the recommendations, the Superannuation Industry (Supervision) Bill (Cth), was introduced into the federal Parliament on 16 December 1992, but, with the dissolution of Parliament for the 1993 federal election, the Bill lapsed. Following the 1993 election the Bill was introduced to the Parliament on 27 May 1993.

Discussion paper (DP 53)

1.12 After completion of the superannuation report, the Review resumed work on the broader reference. In October 1992 it published a detailed discussion paper (ALRC DP 53, 1992) covering the remaining aspects of the reference, relating to collective investment schemes other than superannuation schemes. DP 53 discussed the policy goals of the Review and identified the fundamental issues to be addressed. A further 73 detailed submissions were received in response to DP 53.

Consultations

1.13 ***Consultants.*** Soon after the Attorney-General asked the Review to report on superannuation, the ALRC engaged Mr Paul Klumpes of the Australian National University to provide the Review with an overview of the superannuation industry, its existing regulatory framework and the inconsistencies within that framework.[5] The ALRC also engaged Mr Ian Ramsay of the University of New South Wales to prepare a paper on trustees' duties, company directors' duties and the issues involved in the incorporation of trustees. In accordance with its usual practice, the ALRC appointed a number of honorary consultants to help the Review. They were selected from the funds management and superannuation industries, the legal profession, academia, the public service and the community. The Review acknowledges, with appreciation, their contribution. They attended several lengthy meetings to discuss the Review's proposals and gave valuable assistance in other ways. The Review wishes to express its particular appreciation for the extensive contribution made by Mr Robert Ferguson, Managing Director, Bankers' Trust Australia. Special mention should also be made of Mr Tony Hartnell, former Chairman of the Australian Securities Commission, Mr Don Blyth of the Trustee Companies Association, Mr David Davis of Permanent Trustee Company Limited, Mr Peter Hutley of the Investment Funds Association of Australia, Mr Jim Murphy of the Attorney-General's Department, Canberra, Mr John Rutherford and Ms Chloris Latham of the Australian Securities Commission, Mr George Pooley, the Insurance and Superannuation Commissioner, Mr Donald Magarey of Blake Dawson Waldron and Mr David Purchase of the Life Insurance Federation of Australia. Finally, special mention must be made of Mr Leigh Hall and Mr Jim Armitage. After their term as members of the ALRC ended, they continued to devote considerable time to completing this report.

1.14 ***Consultations.*** In November 1992 the Review held public hearings in Melbourne and Sydney on the proposals advanced in DP 53. It also conducted a number of lengthy consultations with trustee companies, funds managers, consumer and investor groups and federal, State and Territory regulators. In addition, the Review held several meetings with its honorary consultants and addressed a number of meetings and seminars to explain the proposals in DP 53.

Other reports, studies and reviews

1.15 The Review has had regard to a number of other reviews and reports dealing with the specific issues within the scope of the Review's terms of reference. While preparing its interim report on superannuation, the Review maintained close liaison with the Senate Select Committee on Superannuation chaired by Senator Nick Sherry. The Review also contributed to the Trade Practices Commission's report on life insurance agents. Finally, the Review has maintained a close working relationship with the Special Premiers' Conference Working Party on Non-Bank Financial Institutions Sub-committee on Trustee Companies, through its convenor, Dr Paul Moy, of the NSW Treasury.

5. The results of Mr Klumpes' work were published in ALRC Collective Investments Research Paper 1 *A Review of Regulatory Arrangements Applying to Superannuation Schemes in Australia*, July 1992. A member of the Advisory Committee staff, Mr Mark Blair, has also written a paper published separately by the Review: ALRC Collective Investments Research Paper 2 *Review of collective investment schemes in overseas jurisdictions*, June 1993.

Outline of this report

1.16 This report addresses the terms of reference for the Review in the following order. Chapter 2 sets out the policies and principles that collective investment regulation ought to pursue. Chapter 3 identifies what schemes are covered by the report. Chapters 4 to 7 cover various aspects of the day-to-day operation of schemes, including how they are established (chapter 4), what matters need to be disclosed to investors and how that should be done (chapter 5), what borrowing limits, audit requirements and other financial controls should be imposed (chapter 6) and how investors withdraw from schemes (chapter 7). Chapter 8 discusses the procedure for terminating a scheme. Chapters 9 and 10 identify the need for scheme operators to take effective measures to ensure that they comply with the law and the scheme constitution, which is a key factor in the recommended controls on who should be authorised to operate a collective investment scheme. Chapter 11 covers the role investors should play in protecting their interests, while chapter 12 considers whether the present requirement that each scheme have a separate trustee or representative should continue. Chapters 13 and 14 deal with the way intermediaries sell collective investment schemes and the role and powers of the regulator. Chapter 15 considers whether contraventions should be dealt with as offences and makes recommendations about the construction of offences. Finally, chapter 16 deals with the way in which the transition to the new regime should be managed.

2. Policies and principles

Introduction

2.1 The Review's terms of reference require it to assess the legal framework governing collective investment schemes and the extent to which the existing law promotes adequate and effective protection of the interests of investors, commercial stability and efficiency in capital raising and formation. Particular issues that the Review has been asked to address include

- what disclosures should be made to investors by operators
- what prudential arrangements should be imposed on participants in the industry
- the powers, duties and responsibilities of the operators of collective investment schemes
- the appropriate controls over buy-back and redemption of investments.

This chapter discusses regulation in financial markets and the policies and principles underlying the review in this report. It presents the Review's objectives in relation to investor protection, commercial stability and efficiency in capital raising and formation.

Regulation

Role of regulation

2.2 The Review accepts it as fundamental that the level of regulation should be kept to the minimum consistent with the achievement of other policy goals. Because of the significance of collective investment schemes to the national economy, there is an understandable tendency on the part of some commentators to assess existing or proposed regulatory frameworks solely from the standpoint of whether they promote economic efficiency. However there are other policy considerations involved.

> [T]heft has been outlawed to protect individuals, not simply because of its economic consequences. Similarly modern trade practices and consumer protection laws are motivated by a desire to prevent exploitation of the individual by those with greater economic power, greater access to information or greater bargaining strength. More adequate and effective company and securities laws are required on grounds of fairness and commercial morality.[1]

While the Review accepts that a principal criterion for judging the regulation of fund raising activities such as collective investment schemes is an economic one — does the regulation promote efficiency? — it also accepts, as the Rae Committee did, that regulation has an important role in protecting the interests of investors and the wider community from the consequences of low standards of corporate governance. Not to act to protect those interests would impose economic and other

1. Rae Report, 471.

costs on these investors, and on the community as a whole. In some cases these costs may be difficult to quantify. But an assessment of a regulatory regime which ignored them would be seriously incomplete.

Responsibility for regulation

2.3 Who has ultimate responsibility for regulating the collective investments industry is an important issue for the Review. The law could provide for regulators to exercise, for the benefit of the community, quite extensive coercive powers. It may give them power to deny industry participants access to the market, or to set terms and conditions under which industry participants must operate. The law could also authorise regulators to exercise, on behalf of investors, powers that the investors would have difficulty exercising themselves. At present, the ASC has some of these powers. Some industry participants (trustee companies and others who act as trustees or investor representatives) have other powers, either under the law or because of their market position. In view of the significant role that collective investment schemes play in the national economy, ultimate responsibility for ensuring the establishment and operation of an adequate regulatory framework must rest with the Commonwealth. Many of the powers needed for effective regulation will be coercive, involving penalties for non-compliance. These should only be exercised by the state — in this case, the Commonwealth, through the ASC and other relevant agencies. The Commonwealth should not rely on industry self-regulation. It should not hand over responsibility for the regulatory framework to participants in the industry to enforce on behalf of the community.

Protection of investors

An essential policy aim

2.4 The principal aim of the Review is to ensure adequate and effective protection for investors. The Review met widely differing views on what 'investor protection' means. For some it seems to mean that investors will not lose their initial investment, or that they will always receive a positive rate of return on their investment. Given the nature of collective investment schemes, this cannot be correct. To understand what 'investor protection' means in the context of collective investment schemes requires a clear understanding of the risks that investors in these schemes face.

Investor protection and risk

2.5 Investors in collective investment schemes face the risk that some or all of their investment may be lost. The nature and extent of this risk will vary with the kind of investments the scheme makes. However, for all schemes, there are three kinds of risks that may result in a loss by investors (either by reduced value of their investment or by a reduced return on their investment):

- investment or market risk — the risk that the investment will decline in value, either because the market as a whole declines in value or because the particular investments of the scheme decline in value

- institution risk — the risk that the institution which operates the scheme will collapse
- compliance risk — the risk that the operator of a scheme will not follow the rules set out in the scheme's constitution or the laws governing the scheme, or will act fraudulently or dishonestly.

Protecting investors in collective investment schemes

2.6 ***Protection against investment risk.*** Collective investment schemes appeal to a wide range of investors with different investment preferences. Some schemes invest in assets that can be described as highly speculative; others offer a relatively secure investment. The investment risk of a scheme refers to possible variations in an investor's rate of return caused by fluctuations in the resale value of the scheme's assets. One way of reducing investment risk is to impose stringent investment controls on collective investment schemes. These might include, for instance, a requirement for schemes to diversify investments or a prohibition on certain classes of investment. The law governing collective investment schemes cannot — and should not — try to eliminate the investment risks facing investors. If the law attempted this, it would fail. Investors would be deluded into thinking they could not lose their money. Many of the innovative financial products marketed to investors through collective investment schemes would no longer be viable. Investors would have no choices and no ability to accept greater risks for the opportunity of obtaining greater returns. However, the law can and should ensure that investors are given all the information they need to understand fully, and to judge for themselves, the level of investment risk associated with any scheme so that they can choose, with full knowledge, the scheme that best suits their investment objectives.

2.7 ***Protection against institution risk.*** Investors may be attracted to a particular collective investment scheme because of the perceived skill of the scheme operator.[2] Institution risk refers to the risk that the operator will collapse, resulting either in transfer of the operation of a scheme to another operator which some investors would not have chosen, or in the collapse of the scheme. The law cannot ensure that the operators of collective investment schemes will never collapse. To ensure that the collapse of a scheme operator does not result in the loss to investors of any of the scheme's assets, the law should ensure that the scheme's assets are isolated from the collapse of the scheme's operator. What, if any, regulatory controls ought to be imposed to reduce the risk of collapse of the scheme operator is a separate issue.

2.8 ***Protection against compliance risk.*** The law can and should deal with the risk that a scheme operator may not adhere to the scheme's own rules or to the laws governing collective investment schemes, and with the risk that the scheme operator will act fraudulently or dishonestly. The law governing collective investment schemes cannot prevent all instances of non-compliance and dishonesty. It can, however, establish rules to reduce the risk of non-compliance to an acceptably low level. A focus on compliance is a particularly important

2. In unit trusts some investors may be influenced by the identity of the scheme's trustee but more are likely to be attracted by the reputation of the scheme manager.

consideration for the regulatory framework for collective investment schemes because of the limited powers of investors, the restricted investment objectives of many of these schemes and the risk that operators may take actions that are not in the interests of investors. One example is the risk that a scheme operator will try to overpay itself for fees incurred in the management of the scheme. Likewise, the ability of investors to have confidence in the regulatory regime, which is an essential precondition for the Review's goal of promoting commercial stability, requires that investors be protected from unlawful activities of scheme operators. This element of investor protection may also include the need to ensure that, if investors are divided into classes, investors in one class are treated fairly compared with those in another class.

Investor protection and prudential supervision

2.9 Prudential supervision can help to increase the level of protection against institution risk and market risk.[3] In the collective investments industry, prudential regulation can involve either specifying necessary attributes of scheme managers or placing controls on the schemes themselves. There is a variety of prudential measures that could be adopted, including

- requiring that intending scheme operators have the resources to adhere to requirements imposed by law
- imposing standards of honesty and character on operators
- imposing minimum working capital requirements on operators
- imposing minimum liquidity standards or redemption controls on schemes.

Working capital requirements for scheme operators, for example, can reduce the risks associated with the cash flow pattern of the operator. Liquidity and redemption controls on schemes can help to reduce the likelihood of loss to investors caused by mismanagement of scheme assets by the operator. Such prudential controls would impose some costs on collective investment schemes, reduce the range of investment opportunities and could narrow unnecessarily the options available to investors, as some schemes and their operators may not be able to meet the prudential standards. While the new regime should establish minimum standards with which all operators and schemes, whatever their nature, must comply, the standards should not be so strict as to reduce significantly the options available to investors or to erect unwarranted barriers to entry.

Investor protection and disclosure

2.10 As collective investment schemes, and the way in which they are marketed, become more complicated, it is more likely that schemes will be marketed to individuals who lack the financial sophistication to assess the risks involved in investing in them. The law cannot ensure that all intending investors understand the nature of the scheme. It can, and should, impose rules to ensure that

3. Prudential regulation refers to controls over the way in which scheme operators are structured and how they conduct their business.

- the operator of the scheme gives investors all the information relevant to the assessment of risk that the operator has available to it
- information is presented in a clear and comprehensible way and is not misleading.[4]

The focus of the law should be to ensure that investors are as well informed about the scheme as the operator of the scheme.[5] Disclosure by scheme operators is an important way of protecting investors by providing them with information which they need to make a decision about the investments available but which would otherwise not be provided. The need for mandatory disclosure rules tailored to the needs of unsophisticated investors becomes greater where there is neither a well established secondary market with readily observable securities prices nor a large and reliable investment advice system that offers unsophisticated investors professional advice which may be used by investors before making an investment decision.

Investor protection, adequate investor rights and the regulator

2.11 ***The role of the investors.*** Because of the nature of collective investment schemes, investors must play an important role in ensuring that their interests are protected. What precisely that role should be needs to be considered in the light of investor preferences for the balance between involvement and external supervision by a government regulator[6] and the inherent difficulties facing investors who want to act for themselves. The Review has considered a range of self-help remedies in making its recommendations regarding investor rights. It has taken into account the costs and other problems involved in collective action by groups of disparate people.[7]

2.12 ***The role of the regulator.*** The regulator has an independent role in ensuring the proper and effective working of the regulatory regime. It also plays a significant role in ensuring that the rights of investors are able to be enforced. The regulator should be able to exercise, on behalf of investors, powers the investors would have difficulty enforcing because of the cost or difficulties in obtaining the necessary information. The Review has considered a variety of cases where intervention by the regulator on behalf of investors is warranted to ensure their legitimate interests are properly protected.

4. Disclosure documents containing a large amount of information, but with important matters lost in a mass of detail, would not be clear or comprehensible. An example of misleading advertising is a collective investment scheme using the name or logo of a familiar financial institution to suggest that that institution 'backs up' the scheme when the institution does not in any way guarantee the investment.
5. For a discussion of rationales for mandatory disclosure requirements see M Blair 'The Debate Over Mandatory Corporate Disclosure Rules' (1992) 15 *UNSWLJ* 177.
6. See ch 3.
7. See 11. For a discussion of the collective action problem facing investors and the alternative solutions see M Blair & I Ramsay 'Collective investment schemes: the role of the trustee' (1992) 1(3) *The Australian Accounting Review* 10.

The Review's approach

2.13 *Adequate investor protection.* The Review has framed its recommendations so as to instil in investors generally a well founded confidence that the law will protect them against being exploited by scheme operators or others. To this end the Review has considered and made recommendations on

- mandatory disclosure rules
- appropriate deterrents and remedies concerning fraudulent or misleading behaviour on the part of scheme operators or other persons involved in schemes
- controls to resolve potential conflicts of interests between scheme operators and investors, for example, concerning excessive fees and related party transactions
- the powers available to the regulator
- compliance by scheme operators with both the scheme constitution and the collective investments legislation.

Many investors in collective investment schemes are commercially unsophisticated investors and rely heavily on information supplied by the promoter of the scheme to assess the performance of the scheme or the state of their investment. Many, perhaps most, do not wish to be involved in day to day management of their investment funds. This investor preference has been taken into account by the Review in developing its recommendations.

2.14 *Minimising risk.* In formulating its recommendations, the Review has weighed carefully the need for investor protection and possible losses in efficiency. It has concluded that the law should not protect investors from pure investment risk. Investments necessarily entail taking commercial risks. Before entering a scheme, investors must have available to them all relevant information about the investment risk involved. The Review has focussed on developing a legislative framework that, subject to cost-benefit considerations, minimises the compliance risk faced by investors in collective investment schemes and maximises their ability to make properly informed decisions.

Promoting commercial stability

Introduction

2.15 Stability means the avoidance of major fluctuations in the level of and value of investments. Stability contributes to investor confidence, and investor confidence in turn promotes stability. One goal of the regulatory regime ought to be to enhance investor confidence by minimising the risks of unexpected fluctuations or collapses in investment schemes.

Investor confidence essential for commercial stability

2.16 A necessary condition for commercial stability in the collective investment industry is the confidence of investors that

- they are adequately protected against exploitative behaviour by scheme operators
- the industry operates efficiently and effectively.

Lack of confidence on the part of investors may mean that they will be more likely to withdraw their money from collective investment schemes on receiving adverse information concerning the scheme operator. This may destabilise schemes and may have detrimental effects on financial markets and the economy as a whole. The level of commercial stability is therefore closely linked to investor protection and efficiency. A recent example of instability in the Australian collective investments industry has been the collapse of the unlisted property trust market. The instability arose because the illiquid nature of the underlying assets of property trusts was not matched to the rate at which investors could redeem their claims or to investor expectations.

The failure of individual schemes and commercial stability

2.17 The failure of individual schemes will not necessarily lead to instability in the collective investments industry. One or more isolated failures may be of little consequence to investors in similar collective investment schemes, particularly where they recognise that the failure was due to poor investment decisions on the part of the particular scheme operator. There are clearly occasions, however, where the failure of a scheme is believed by investors to be a function of an inadequate regulatory framework. Such a failure can cause investors in similar schemes to attempt to withdraw from their schemes, causing these schemes to collapse. This is known as 'contagion'.

The Review's approach

2.18 The Review acknowledges the importance of maintaining commercial stability in capital markets. A regulatory regime which does not provide incentives to encourage this stability is likely to reduce investor confidence and hence the willingness of individuals to commit their savings to collective investment schemes. This reduces the overall level of savings in Australia and thereby either increases our reliance on overseas funds to maintain our current levels of investment or leads to falls in the levels of investment and, consequently, a decline in economic growth. Even if the level of savings is not diminished, commercial instability in collective investment schemes may result in a distorted pattern of savings and investment which would inhibit Australia's economic growth. The Review recognises that it needs to consider the impact which its recommendations could have on the stability of the collective investments industry and has framed its recommendations accordingly.[8]

8. One aspect of this is the question how to manage the transition from the current regime to that proposed in this report: see ch 16.

Efficiency in capital raising and formation

The importance of efficiency

2.19 Maximising the efficiency of capital formation is important for Australia's economic well being. Clearly, if the regulatory regime imposes more costs on fund raisers than are necessary to provide the appropriate level of investor protection, the system is inefficient. As a consequence some investments may not be undertaken because the rate of return generated would not be high enough to make the investment attractive. Australia's economic growth will be reduced as a result.

Three types of efficiency

2.20 *Introduction.* There are three types of efficiency in capital raising and formation:

- allocative efficiency
- operational efficiency
- dynamic efficiency.

Securities regulation should be framed so as to promote each of these.

2.21 *Allocative efficiency.* Allocative efficiency in the context of collective investment schemes refers to the extent to which the economic system directs savings into the highest yielding investments. Information flows between participants in the industry play an important role in this. There is considerable support for the view that market forces, if left unfettered, will not result in the necessary level or type of disclosure in capital markets.[9] Proponents of this view argue that, to assess which investments offer the highest yields, investors need access to information above and beyond what scheme operators would otherwise be willing to provide. In other words, they contend that the allocative efficiency of the market for collective investment scheme investments may be improved by mandatory financial and other disclosure rules for scheme operators. However, regulation that stifles the market by unnecessarily reducing the possible returns to investors needs to be avoided.

2.22 *Operational efficiency.* Operational efficiency refers to how schemes are managed. One way to enhance the operational efficiency of collective investment schemes would be to impose requirements for particular corporate governance standards, such as the involvement of non-executive directors. The extent to which this kind of regulation should be imposed is an issue for the Review. Alternatively, market forces could be relied on to provide incentives for improved operational efficiency. For this to work effectively, investors must be able to discipline scheme operators for inefficient behaviour, including replacing them if that becomes necessary.

9. See, eg, JC Coffee 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717.

2.23 ***Dynamic efficiency.*** Dynamic efficiency refers to the capacity of a system to adapt to changing needs, generate innovations and raise productivity. The dynamic efficiency of the collective investments industry may be promoted, for example, by allowing scheme participants flexibility in the legal form and administrative arrangements that they adopt. Conversely, certain forms of regulation, such as a prohibition on certain classes of investment, may impair the ability of schemes to adapt to changing market conditions.

The importance of competitive neutrality for efficiency

2.24 ***The principle.*** A fundamental principle of economics is that competition is essential if a market is to produce an efficient outcome. This principle applies to securities markets as it does to markets for goods and services. There may be impediments to competition if different institutions offering functionally similar financial products face different regulatory regimes. Indeed, if different regulatory regimes exist, the offerors of functionally similar financial products may not perceive themselves as potential competitors. Potential investors also may not consider the comparative costs and benefits of investment in each product.

2.25 ***Functional versus institutional regulation and competitive neutrality.*** Traditionally the regulation of fund raising schemes has been based on the type of institution operating the scheme. This approach assumed that the kinds of risk borne by investors depended principally on the type of institution raising the funds, and that investors were choosing among different institutions offering the same product rather than among different (though functionally similar) products. In recent years new types of financial products have been developed. There has also been a trend toward financial conglomeration resulting in the emergence of financial 'supermarkets'. As a consequence of these developments, the kinds of risks facing investors no longer necessarily coincide with the kind of institution raising the funds.[10] Major inconsistencies in the regulation of functionally similar financial products as a result of the current regulatory regime relate to

- disclosure requirements
- capital requirements of offerors
- investment controls
- liability of offerors
- taxation treatment.

Differential regulation of this kind is likely to result in a reduction in effective competition and therefore in overall economic efficiency. If it is accepted that fund raising vehicles performing the same function should not be regulated differently merely because they are operated by different institutions, a functional rather than an institutional approach to regulation is required. A regulation by function approach should increase competition by promoting a 'level playing field'.

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10. Life insurance companies, which have traditionally offered investors products that are capital guaranteed (such as term life insurance and endowment assurance policies), now offer investment products in which the investor bears the investment risk. Yet the regulation of this type of fund raising activity by these institutions still incorporates many features that were developed for 'traditional' insurance products.

The Review's approach

2.26 ***Review of existing requirements.*** The Review accepts as important the economic arguments in favour of constructing a regulatory regime for collective investment schemes which aims to maximise the efficiency of the schemes and ensures investors have the widest possible choice. The Review has examined thoroughly the existing legislative requirements pertaining to the various forms of collective investments, so as to ensure that collectively they represent the best way of achieving efficiency in capital raising and formation and maximising investor choices.

2.27 ***Different regulatory regimes.*** The approach of the Review has been to ensure that, wherever possible, the law promotes competitive neutrality between different legal structures that provide functionally similar services to investors. This does not require the details of the regulatory regime applying to each type of functionally similar scheme to be identical. The regulatory impact should, however, be the same. The Review has taken into account the need to balance the benefits of establishing a competitively neutral regulatory regime with the potential for commercial instability in areas such as the regulation of investment schemes offered by insurance companies, friendly societies and statutory trustee companies. The Review has consulted widely on the appropriate legal framework for these schemes.

3. What is a collective investment scheme?

Introduction

3.1 The terms of reference require the Review to examine the regulatory framework for prescribed interests and like collective investment schemes. 'Prescribed interest' and 'collective investment scheme' are both artificial concepts. All schemes that raise funds from investors and invest the funds could be called collective investment schemes in the broadest sense of the term. This chapter considers which of them should be a 'collective investment scheme' for the purposes of the Corporations Law. It considers each of these kinds of scheme in turn to see if any of them should be excluded from regulation as a collective investment scheme under the Corporations Law. It concludes with a brief outline of the regime proposed by the Review for the regulation of collective investment schemes under the Corporations Law. For ease of understanding, throughout the remainder of this report (unless otherwise indicated) the term 'collective investment schemes' means those schemes that have been defined in this chapter to be 'collective investment schemes' for the purposes of the Corporations Law.

Current regulation of investment vehicles

3.2 The current regulation of investment vehicles is a mixture of functional and institutional regulation. As a consequence of ad hoc decisions taken in the past there are some anomalies in the regulatory framework. The question how new investment vehicles should be regulated and by whom can still be difficult to resolve.[1]

Investor preferences and regulation of fundraising

3.3 Investors are not all the same. There is a spectrum of different types of investors. At one end are investors who want certainty that their funds will be returned to them at the expiry of the investment period or on demand. They rely on an explicit or implied government guarantee or extensive prudential supervision[2] of their chosen fundraising vehicle to ensure that they are able to recover their investment. They are prepared to accept a more modest return on their investment as a trade off for this security. At the opposite end of the spectrum are those investors who do not want a government regulator controlling on their behalf the activities of the fund raising vehicle in which they have invested. For this type of investor regulation protects their right to become involved in the decisions of the fund raising scheme in which they have invested and ensures that they can enforce

1. Until recently, for example, Pooled Superannuation Trusts (PSTs) were regarded by the ASC as prescribed interest schemes under the Corporations Law and by the ISC as a type of superannuation scheme and therefore subject to OSSA. Investment linked life insurance policies are other products that are regarded by some as prescribed interests and by others as life insurance policies and, therefore, outside the scope of the Corporations Law.
2. Prudential supervision is discussed in para 2.9.

their rights if necessary. Some of these investors will take a very active part in the management of their investment. Others will not take up the option available to them. Investors who chose these kinds of schemes are prepared to forego prudential supervision of their investment in return for the opportunity to exercise control over their investment. The regulation of fund raising vehicles needs to recognise this spectrum of investor preferences. Collective investment schemes may be characterised as falling between the two extremes of close prudential supervision and investor self regulation. They appeal to investors who accept that their investment is not guaranteed or prudentially supervised and therefore entails investment risk. At the same time these investors do not seek to become involved in the day to day management of their investment, preferring these decisions to be taken by others subject to some controls. They do not, however, seek a regulatory regime designed only to provide a framework in which they alone regulate their own affairs. The Review has sought in this report to consider existing fund raising vehicles on a consistent basis using this spectrum as a framework to identify which ones should be included or excluded from the definition of collective investment schemes. There are inevitably some anomalies.

Schemes the subject of this report

Prescribed interest schemes

3.4 The Corporations Law defines a prescribed interest as

- a participation interest, that is, an interest
  - in any profit, asset or realisation of any financial or business undertaking or scheme
  - in any common enterprise in relation to which the holder of the right or interest is led to expect profits, rent or interest from the efforts of the promoter of the enterprise, or a third party
  - in an investment contract
- a right to participate in a time-sharing scheme.[3]

This definition is very broad. Most kinds of fund raising schemes that should be covered by the definition of the term 'collective investment scheme' are included. However, it is too broad. Some fund raising schemes and other arrangements are therefore specifically excluded: rights or interests in a trust not established by a 'promoter' or a private trust where the deed provides for not more than 15 beneficiaries,[4] franchises,[5] retirement village schemes,[6] certain joint ventures,[7] time

3. Corporations Law s 9.
4. Corporations Regulations reg 7.12.04(c)(i), 7.12.04(c)(iii). The ambit of these exemptions is unclear and possibly wider than intended. There may also be a possibility of circumvention by creation of rights or interests under a trust without the use of a trust deed: I Ramsay 'Flaws in the prescribed interest provisions of the Corporations Law' (1991) *Butterworths Corporation Law Bulletin*, 425.
5. Corporations Regulations reg 7.1.02.
6. Corporations Regulations reg 7.12.04(a).
7. Corporations Regulations reg 7.12.04(b).

sharing schemes[8] and various partnership agreements[9] and interests in, or arising out of, life insurance policies.[10] These exclusions have been made on an ad hoc basis.

Prescribed interests to be the basis of the definition

3.5 DP 53 expressed concern at some apparent anomalies arising from the current definition of 'prescribed interest' and considered whether an alternative definition could be developed which did not require the exclusion of so many different types of scheme.[11] It suggested that the definition should focus on schemes that provide investors with a funds management function. Suggested identifying features included

- pooling of resources by investors
- an absence of day to day control of the management of the scheme by investors
- investors having the right to redeem their investments.[12]

It proposed that managed funds should not be able to seek exemption from the requirements imposed by the Corporations Law, which would be designed with such schemes in mind.[13] While some submissions supported this approach,[14] others expressed concern that the proposal did not provide enough flexibility for 'managed funds'.[15] The Review now accepts that it is not possible to replace the existing definition of 'prescribed interest' with a more precise definition of 'collective investment scheme' which applies to fund raising schemes other than those which are prudentially supervised or schemes in which the investors themselves are primarily responsible for the conduct of their scheme. The Review therefore **recommends** that the existing definition of prescribed interests in the Corporations Law should be the basis of the definition of 'collective investment schemes' to which the regulatory regime recommended in this report will apply. The Review also **recommends** that the expression 'prescribed interests', which is a less than helpful expression except to the cognoscenti, be abandoned in favour of 'collective investment schemes'.

8. NCSC Release 117; ASC Media Release 92/149.
9. See *ASC v Woods and Johnson Developments Pty Ltd* (1991) 6 ACSR 191 and ASC Media Release 92/76.
10. Corporations Law s 9.
11. DP 53 para 3.17-3.21.
12. DP 53 para 3.37-3.40. The Review acknowledged that not all collective investment schemes provide a funds management function, particularly 'enterprise' schemes such as yabbie or ostrich farms and recreational or 'lifestyle' schemes.
13. Proposal 3.3.
14. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Commonwealth Attorney General's Department *Submission* 21 December 1992.
15. IFA *Submission* 1 December 1992; Law Council of Australia *Submission* 16 December 1992.

Specific inclusions

3.6 ***Trustee company common funds.*** These funds are assumed to fall within the definition of prescribed interests under the Corporations Law. However, if the money contributed to a common fund is a private client contribution, that is, money derived from deceased estates or private trusts administered by the trustee company or otherwise held or received by the trustee company on the basis that it has total discretion whether to invest in a common fund, the assumption is that no "issue, offer or invitation" is involved and, consequently, that the regulatory regime for prescribed interests does not apply. Common funds that receive money otherwise than as a private client contribution, so that a registered prospectus is required, have been granted relief from complying with certain of the prescribed interest provisions of the Corporations Law, such as the requirement for a separate trustee and some of the prescribed covenants.[16] DP 53 suggested that trustee company common funds, unless they receive money solely in the form of private client contributions, should not be exempt from the provisions of the Corporations Law simply because they are managed by statutory trustee companies. It also proposed that private client contributions should be placed in separate common funds from those in which contributions from other sources are placed.[17] Submissions from statutory trustee companies supported a continued exclusion[18] but other submissions agreed with the proposal.[19] The Review has concluded that the arguments for excluding all trustee company common funds from the regulation that applies to collective investment schemes are unpersuasive. It agrees, however, that funds with only private client contributions should not be regulated by the collective investment provisions of the Corporations Law.[20] A distinction should be drawn between common funds that contain only private client contributions and other common funds. The Review **recommends** that common funds that contain any money that is not a private client contribution should be regulated by the collective investment provisions of the Corporations Law. They should not be granted exemptions from those provisions merely because they are operated by a trustee company. Under the Review's recommendation, common funds that are regulated by the collective investment provisions of the Corporations Law will be able to receive private client contributions.

3.7 ***Limited partnerships.*** The law governing limited partnerships makes no provision for their prudential supervision. Limited partners are, however, precluded from significant involvement in the management of the affairs of the partnership. Their position is, therefore, similar to investors in other collective investment schemes. Limited partnerships have proved a popular vehicle for financing infrastructure projects such as power stations. The Corporations Regulations make limited partnerships that have, or are intended to have, more than 15 partners or that are promoted by a person who is not a partner in the

16. ASC Policy Statement 32.
17. Proposal 14.1.
18. eg TCA *Submission* 17 December 1992; cf Permanent Trustee Company *Submission* 12 November 1992.
19. eg IFA *Submission* 1 December 1992; Law Council of Australia *Submission* 16 December 1992.
20. Just as those funds are now not regulated by the prescribed interest provisions of the Corporations Law because no issue, offer or invitation is involved.

partnership or by an associate of a person whose ordinary business includes the promotion of similar schemes prescribed interests.[21] The Review considers that those limited partnerships should be regulated as collective investment schemes because the limited partners in a limited partnership are not able to regulate their affairs themselves and limited partnerships are not otherwise prudentially supervised. The Review **recommends** accordingly.

Arrangements not involving investment excluded

Employment schemes

3.8 There are some schemes which are currently regulated as prescribed interest schemes but which should not be because they are not true investment arrangements. For the sake of certainty, they should be specifically excluded from the regime recommended by the Review. Employee benefit schemes seek to provide to employees benefits in the nature of salary. The consideration or subscription for obtaining an interest in these schemes is not money or some other asset; it is providing services as an employee. The Review **recommends** that the collective investment provisions of the Corporations Law should not apply to schemes of this kind.

Retirement villages

3.9 A retirement village scheme is likewise not an investment. Its purpose is to provide long-term accommodation on a freehold basis for retirees. However, it was not clear that they were not caught by the definition of prescribed interests in the Corporations Law. To clarify that they should not be included they have been specifically excluded from the application of the prescribed interest provisions of the Corporations Law. The Review **recommends** that the present exemption in the Corporations Law for such schemes should continue. The collective investment provisions of the Corporations Law should not apply to them.

Government guaranteed investment schemes excluded

3.10 Government bonds are issued either directly by governments or through statutory authorities. The repayment of money invested in government bonds is ultimately guaranteed by the relevant federal, State or Territory government. The risk that the government will not pay investors the amount owed when it falls due is minimal. Because of the government guarantee, investors in these bonds do not need to protect their interests by taking action themselves. Accordingly, the law does not provide for their direct involvement in decisions affecting their investment. The Review **recommends** that bonds issued by the Commonwealth or a State or Territory government, or statutory authorities or corporations owned by them, should be excluded from the definition of 'collective investment scheme' in the Corporations Law.

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21. Corporations Regulations reg 1.13A.

Schemes operated by prudentially supervised institutions excluded

Banks

3.11 Banks are prudentially supervised by the Reserve Bank of Australia (RBA) under the *Banking Act 1959* (Cth).[22] Many investors mistakenly believe that the repayment of deposits with banks is guaranteed by the Commonwealth. The Commonwealth, under the *Banking Act*, requires the RBA only to protect the interests of depositors, not to guarantee deposits with banks.[23] The RBA is not legally obliged to provide a 'lender of last resort' facility to any bank. The RBA seeks to ensure that banks will be able to repay investors by imposing prudential controls on banks.[24] As a last resort, the RBA has the power to take over the operations of a bank.[25] Given the high level of protection provided to those who invest through bank deposits as a result of the extensive prudential supervision of banks, the Review **recommends** that deposits with Australian banks that are regarded by the RBA as part of a bank's banking business should be excluded from the definition of 'collective investment scheme' in the Corporations Law.

Building societies and credit unions

3.12 Until recently the level of prudential supervision of building societies and credit unions varied from jurisdiction to jurisdiction. A co-operative framework for the prudential supervision of building societies and credit unions was established in 1992.[26] The Australian Financial Institutions Commission (AFIC) is now responsible for establishing the standards of prudential supervision for building societies and credit unions throughout Australia, similar to those imposed on banks by the RBA. Compliance with these standards will be monitored in each State and Territory by an industry funded supervisory body. The position of these financial institutions is now similar to that of banks. They should be excluded from the definition of 'collective investment scheme' in the Corporations Law for the same reason. The Review **recommends** that deposits with building societies or credit unions regulated under the uniform Financial Institutions Codes should be excluded from the definition of 'collective investment scheme' in the Corporations Law.[27]

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22. The RBA recently entered into formal arrangements with those State governments still operating State Banks to permit the RBA to supervise these banks. The Commonwealth has no separate constitutional power over State banks.
23. *Banking Act 1959* (Cth) s 12.
24. For details of the capital adequacy rules for banks see RBA Prudential Statement C1, August 1988, 22.
25. *Banking Act 1959* (Cth) s 14(2).
26. 'Template' legislation establishing AFIC was passed in Queensland and adopted in the other States and Territories.
27. The draft Bill in Volume 2 of this report refers to building societies and credit unions as 'locally regulated financial institutions'.

Life insurance companies

3.13 ***Investment linked policies.*** Traditional life insurance policies require the life insurance company to bear a mortality risk.[28] Life insurance companies have therefore been subject to quite stringent prudential supervision to ensure they have the financial capacity to meet the obligations that may arise from these policies. Life insurance companies have, however, for some time offered insurance contracts that are 'investment linked' (that is, the value of an investor's interest changes in line with changes in the value of the underlying portfolio of assets). They have regarded this class of contract as falling within the exemption from the prescribed interest provisions of the Corporations Law for 'any interest in, or arising out of, a policy of life insurance'[29] on the basis that the policies may contain some death cover. The Review is not convinced that this is correct in law. Such schemes typically involve the allocation of a number of units, each representing an equal share in the investment portfolio, to an investor's account. The kind of assets included in an investor's portfolio (such as shares, fixed interest securities or property) can often be selected by the investor, in the same way that investors in unit trusts can satisfy their investment preferences by choosing a unit trust that invests in the assets or asset classes that match their preferred investments. It appears to the Review that these investment contracts perform the same role as other collective investment schemes.

3.14 ***General approach.*** In principle, therefore, investment linked policies should be regulated in the same way as collective investment schemes. DP 53 suggested that this should be achieved by specifically including these policies in the definition of collective investment schemes.[30] Submissions, particularly from life insurers and from the ISC, opposed this suggestion.[31] After consultation with the life insurance industry and the ISC, the Review accepts that, with appropriate modifications relating to disclosure and marketing, the protection afforded investors by the existing law governing life insurance companies could be made appropriate, given the nature of the contract between investor and the life insurance company. If these modifications were made, there would be insufficient justification for the difficulty and cost of transferring responsibility for the regulation of these schemes from the ISC to the ASC, thus subjecting life insurance companies to supervision by two regulators.

3.15 ***Recommendation.*** Unlike the Corporations Law, the *Life Insurance Act 1945* (Cth) presently contains no general requirements for disclosure to the potential policy holder. Insurers voluntarily disclose a number of similar matters as a matter of practice and the ISC has issued circulars which set out an agreed industry position on the appropriate level and kind of disclosure. However, compliance with the circulars is not mandatory and the legal consequences of incorrect or misleading

28. ie the insurance company runs the risk with each holder of this type of policy that their policy will have to be paid out before the insurance company makes a profit from the policy.
29. Corporations Law s 9.
30. Proposal 12.2.
31. National Mutual Life Association *Submission* 3 December 1992; AMP Society *Submission* 30 November 1992; Mercantile Mutual Holdings Limited *Submission*; ISC *Submission* 16 December 1992; MLC Life Limited *Submission* 18 December 1992; LIFA *Submission* 18 December 1992.

disclosure differ from the consequences under the Corporations Law of incorrect or misleading disclosure.[32] The Review has concluded that it is important that the disclosure regime for investment based products of life companies be similar to the regulation of collective investment schemes under the Corporations Law. It considers that the LIA should be amended to impose on life insurers and their agents the same requirements as to the level and kind of disclosure as are imposed on offerors of interests in collective investment schemes under the Corporations Law. It **recommends** that, if the LIA is not amended in this way within 18 months of the release of this report, investment linked policies should be regulated under the collective investment provisions of the Corporations Law. If the LIA is amended as recommended, all products offered by life insurance companies should be excluded from the collective investments regime proposed in this report.

Friendly societies

3.16 In many ways friendly societies are similar to life insurance companies. Traditionally, friendly societies were groups of workers who made small, regular contributions to a common fund which could be used to fund sickness payments, funeral benefits, invalid pensions and the like. They were first formed in Australia in the 1830s. The 'social service' payments provided by friendly societies have largely been replaced by government funded welfare. Friendly societies now offer members funeral benefits, 'top up' sickness insurance, disability insurance, health insurance and retirement products based on managed funds. Although essentially insurance companies, friendly societies are not regulated by the ISC. They are currently subject to the Corporations Law when they offer prescribed interests to investors, except in some situations, for example, when the offers are made within the State in which the society is established. Currently, they are also subject to legislation in each State and Territory.[33] The Review has been told that proposals for the regulation of disclosure about and marketing of investment products by friendly societies being developed by the Special Premiers' Conference Working Party will follow closely the requirements in the Corporations Law in respect of disclosure and the marketing of securities. The Review therefore **recommends** that all products offered by friendly societies should be exempted from the application of the collective investment provisions of the Corporations Law. This recommendation, like the recommendation in respect of investment linked life insurance policies, is conditional on the disclosure and marketing laws being similar for friendly societies' investment products as for collective investment schemes and on them being implemented in a reasonable period.

Superannuation schemes

3.17 Superannuation schemes are also subject to significant prudential supervision.[34] In its report *Collective investments: superannuation* (ALRC 59, 1992), the Review dealt exhaustively with superannuation schemes, approved deposit funds (ADFs), deferred annuities (DAs) and pooled superannuation trusts (PSTs). That

32. Currently, the TPA does not apply to all disclosures, or to lack of disclosure, by life insurers.
33. eg *Friendly Societies Act 1989* (NSW).
34. However, members of accumulation schemes bear the investment risk arising from the scheme's investment activity.

report made detailed recommendations about the prudential and other controls that ought to be imposed on schemes of this kind. The federal Government announced on 21 October 1992 that it had accepted most of the recommendations in the report, and the Superannuation Industry (Supervision) Bill 1993 (Cth) was introduced on 27 May 1993. The Review **recommends** that superannuation funds, ADFs, DAs and PSTs regulated under the Superannuation Industry (Supervision) Bill 1993 (Cth), when enacted, should not be subject to the collective investments regime recommended in this report. The special features associated with superannuation, including the facts that it is now virtually compulsory and that many schemes will have to have employee representatives involved in the supervision of schemes, make it appropriate that superannuation be regulated separately from other collective investment schemes.

Schemes that provide for investor participation excluded

Introduction

3.18 There are many schemes which are not otherwise subject to significant prudential supervision that are subject to regulation which aims only to provide investors with the opportunity to protect their own interests by becoming involved in the decisions concerning their investment. These schemes include

- joint venture schemes
- intra group schemes
- franchises
- partnerships (other than limited partnerships)
- direct investment in corporations through shares or debentures
- professional investor schemes
- small schemes.

To regulate them under the collective investment provisions of the Corporations Law would be contrary to the preferences of investors who have chosen to invest in those fund raising schemes because they allow a greater degree of investor participation than is provided for investors in collective investment schemes. Some of these schemes are, and should remain, subject to other provisions of the Corporations Law relating to securities generally.

Joint venture schemes

3.19 A key characteristic of joint ventures appears to be that the joint venturers often contribute specific assets or expertise, rather than merely capital. This kind of scheme has a degree of investor involvement that makes the application of the Corporations Law collective scheme provisions inappropriate. The joint venturers' rights would be restricted by these provisions to a degree that would make the schemes unworkable. The Review **recommends** that joint venture arrangements should not be regulated by the collective investment provisions of the Corporations Law. To guard against abuse of this exemption the Review **recommends** that the exclusion should only apply to arrangements that the ASC declares to be joint ventures.

Intra group schemes

3.20 Some schemes are designed simply to facilitate the operation of a group of companies as between themselves. Given the essentially private nature of such an arrangement and the fact that the 'investors' will all be within the same corporate group, the Review **recommends** that schemes where the only 'investors' are bodies corporate related to each other should not be regulated by the collective investment provisions of the Corporations Law.

Franchises

3.21 Franchise arrangements usually involve the purchaser obtaining the right to use a particular name and the franchise owner providing back up support and ensuring standardisation of marketing. Franchises involve a degree of investor involvement in the day to day management of the investment. This makes the application of the collective investment provisions of the Corporations Law inappropriate. The Review **recommends** that franchise arrangements should not be regulated by those provisions.

Partnerships

3.22 A partnership clearly involves a collective investment by the partners in the partnership. Partnership law assumes that the partners will themselves determine what level of involvement they will have. The law should not interfere with this arrangement. The Review therefore **recommends** that the existing exclusion of partnerships from the scope of the 'prescribed interest' provisions be maintained. Partnerships should not be regulated under the collective investment provisions of the Corporations Law. The existing exclusion does not cover certain limited partnerships or partnerships promoted by or on behalf of a person who promotes similar partnerships or schemes. This exception to the exclusion should continue.[35]

Fundraising by corporations

3.23 ***Shares.*** Equity capital (shares) is an important source of capital for corporations. The Corporations Law provides for a comprehensive regulatory framework for shares which provides shareholders with the opportunity to exercise a greater level of involvement in the activities of the corporation than is available to investors in collective investment schemes under the Review's recommendations. DP 53 proposed that the regulation of shares be excluded from the definition of collective investment scheme. The Review affirms that view and **recommends** that shares not be regulated by the collective investment provisions of the Corporations Law.

3.24 ***Debentures and notes.*** Another important source of finance for corporations is borrowings from the public. These borrowings frequently take the form of debentures or notes. The repayment by the corporation of these debts is also very often secured against particular assets of the corporation. They are not, however, a

35. Corporations Law s 9; Corporations Regulations reg 1.13A. Limited partnerships are dealt with in para 3.7.

collective investment in the corporation by the lenders. The use of this form of fund raising scheme by corporations is comprehensively regulated by the general provisions of the Corporations Law which provide the regulatory framework in which any dispute as to the rights of the parties set out in their own agreements between themselves will be resolved. DP 53 proposed that all debentures and notes be excluded from the definition of collective investment schemes. The Review affirms that view. It **recommends** that debentures and notes should not be regulated by the collective investment provisions of the Corporations Law.

3.25 ***Investment companies.*** The ASC urged the Review to examine the regulation of investment companies under the Corporations Law Pt 4.4.[36] It indicated that the present regulatory provisions have been found to be unworkable. In 1986, the NCSC decided as a matter of policy not to declare a company to be an investment company under Pt 4.4 because it considered the provisions inappropriate. There is, therefore, no special regulatory regime in effect for investment companies. Specific regulatory issues raised by the ASC include

- conflicts of interest where a sponsor related investment manager is employed
- inconsistencies between the regulation of investment companies and the regulation of similar investment schemes.

Investment companies, because of their corporate form and because of the extent of the regulation imposed on them under the Corporations Law, pose particular problems. The Review has not addressed those problems in this report. They should be the subject of a separate report. The Review **recommends** that the matter be referred to it.

Professional investors

3.26 ***DP 53 proposal and submissions.*** DP 53 questioned whether collective investment schemes offered to so-called 'institutional' or professional investors should be covered by the Corporations Law regulation of collective investment schemes. It proposed that such schemes should be subject to those provisions unless an exemption is obtained from the regulator.[37] Several submissions proposed an automatic exemption for collective investment schemes whose investors are all 'professional'.[38] They argued that an investor with a significant sum to invest has enough incentive to take an active interest in the scheme. The Review agrees.

3.27 ***'Professional investor' defined.*** The Corporation Law currently defines as an excluded offer any scheme in which each investor has contributed at least \$500 000.[39] The Review accepts that investors who place \$500 000 in a single investment have sufficient commercial incentive to take a high level of interest in what happens to their investment. This high level of interest and, in many cases, involvement, makes it inappropriate to regulate such schemes as collective

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36. ASC *Submission* 23 December 1992.
37. DP 53 para 3.25.
38. BT *Submission* 15 December 1992; MLC Life Limited *Submission* 18 December 1992.
39. Corporations Law s 66.

investment schemes under the Corporations Law. It would unduly restrict their opportunities for involvement by investors in such schemes The amount required to be invested by each investor before a scheme can gain this exemption from the collective investment provisions of the Corporations Law should be able to be increased by regulation to avoid inflation removing some investors from the coverage of the law.

3.28 ***Recommendation.*** The Review **recommends** that schemes the minimum initial subscription for which is at least $500 000 should not be regulated by the collective investment provisions of the Corporations Law. It should be made clear, however, that interests in such schemes will continue to be securities for the purposes of the Corporations Law and so subject to the general prohibitions in the Corporations Law against misleading or deceptive conduct in relation to securities.[40]

Small schemes

3.29 Collective investments include schemes that are small in size and open only to a small group of people. An example is a group of friends who regularly pool money for lottery tickets or Lotto.[41] The protective measures recommended in this report for collective investment schemes are not appropriate for arrangements of this kind. The Review therefore **recommends** that schemes that are structured so that they cannot accept from their investors more than $100 000 in total should not be regulated by the collective investment provisions of the Corporations Law.[42]

Exclusion by regulation

3.30 In view of the broad range of fund raising schemes covered by the Review's definition of 'collective investment scheme', it is possible that not all aspects of the law regulating collective investment schemes will be appropriate for all schemes. The Review recognises that it will be important to be able to modify the application of the law where appropriate. In particular cases this could go as far as excluding a scheme or a class of schemes from the application of the collective investment provisions of the Corporations Law. The Corporations Law already excludes from the coverage of the prescribed interest provisions of the law a variety of issues, offers and invitations to invest, either generally or from particular provisions.[43] It also allows the ASC to exempt persons or a particular class of persons, either generally or otherwise, from compliance with the provisions of a number of divisions of the Corporations Law.[44] The kinds of collective investment schemes which should be excluded may well change over time as new types of fund raising vehicles develop. Rather than attempt to anticipate this, it seems more appropriate to provide, as the Corporations Law does now, for individual schemes and classes of collective investment schemes to be excluded, either wholly or in part, from the new regime. The Review **recommends** that s 1084 should continue. The ASC

40. eg Corporations Law s 995.
41. But note that racehorse syndicates are in an entirely different position.
42. The figure of $100 000 should be able to be altered by regulation.
43. Corporations Law s 66.
44. s 1084.

should be able to modify, including by exclusion, the application of the collective investment provisions of the Corporations Law to schemes or classes of schemes. The Review has considered whether such a wide power is an inappropriate delegation of legislative power. It considers that, in light of the broad definition of collective investment schemes,[45] and the fact that many of the provisions of the regulatory regime will be inappropriate or unnecessary for some schemes, the power to grant exemptions represents an appropriate balance between parliamentary supremacy and the practical application of the law. It is important to ensure that, where the Parliament delegates any power, it is kept informed of the exercise of that power. The Review **recommends** that the ASC should report annually to the Parliament on the number and kind of exemptions it granted during the year.

An outline of the proposed regime

3.31 The rest of this report sets out the detail of the Review's recommendations for collective investment schemes that ought to be regulated under the Corporations Law. Those recommendations will result in collective investment schemes being established by the operator of the scheme applying to the ASC for registration of the scheme as a collective investment scheme and for the issue to it of a scheme operators licence, authorising it to accept subscriptions and otherwise carry on the business of the scheme. While the registration of the scheme as a collective investment scheme is a formal matter, principally to enable people to identify the scheme, the scheme operators licence application is designed to allow the ASC to assess whether the operator

- has compliance measures that are reasonably likely to ensure that it complies with the scheme constitution and the Corporations Law
- meets a minimum capital.

Neither the licence nor the registration is intended to assess the commercial viability of the scheme or the professional expertise of the operator. Specific controls are imposed on the way in which the scheme operator will deal with the funds subscribed. Extensive provision is made for reporting to investors and to the ASC. The present buy back obligation is to be abolished, to be replaced by rules ensuring that buy backs by the operator and redemptions of interests out of scheme assets do not prejudicially affect the viability of the scheme or the interests of other investors. In the light of all the proposed reforms, it can be left to scheme operators and their perceptions of investors' wishes to decide whether to involve a second party, such as a statutory trustee company, in the running of the scheme.

45. Which is necessary to ensure that the regulatory regime encompasses all the schemes it should.

4. Establishing a collective investment scheme

Introduction

4.1 This chapter deals with a number of matters concerning the way collective investment schemes are established. It covers whether a particular legal form should be prescribed for collective investment schemes, the constitution of schemes and whether the constitution should have to be approved by the ASC before the scheme can be marketed to investors. It also covers the question whether the covenants presently prescribed by the Corporations Law should continue. Whether the operator of a collective investment scheme should have to be licensed is addressed in chapter 10.

Legal form of collective investment schemes

4.2 A prescribed interest scheme under the present law includes schemes structured as trusts, partnerships and, in some instances, investment contract schemes.[1] This recognises that the legal form of a scheme is in some ways irrelevant to the question what protection should be afforded to investors in the scheme. DP 53 sought views on whether the law should impose any constraints on the legal structures available for schemes. The majority of submissions opposed the idea of a single legal structure for collective investment schemes.[2] The Review sees no reason to limit artificially the legal form of collective investment schemes. The recommendations in this report will provide appropriate investor protection for all collective investment schemes governed by the Corporations Law. So long as those protections apply there is no need to prescribe the forms that collective investment schemes may take. The Review **recommends** that the Corporations Law should not prescribe a particular legal form for collective investment schemes.

A scheme's constitution

A written constitution

4.3 Under the present law, each prescribed interest scheme must have a deed that sets out the elements of the scheme and includes the covenants prescribed by the Corporations Law, or covenants to the same effect.[3] It is important that collective

1. An investment contract is 'any contract, scheme or arrangement that, in substance and irrespective of its form, involves the investment of money in or under such circumstances that the investor acquires or may acquire an interest in, or right in respect of, property, whether in [the] jurisdiction or elsewhere, that, under, or in accordance with, the terms of investment will, or may at the option of the investor, be used or employed in common with any other interest in, or right in respect of, property, whether in [the] jurisdiction or elsewhere, acquired in or under like circumstances': Corporations Law s 9.
2. eg IFA *Submission* 1 December 1992; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992; ISC *Submission* 16 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992.
3. It is an offence to issue prescribed interests unless the deed is approved by the ASC: Corporations Law s 1065.

investment schemes continue to be constituted by a written document, for evidentiary purposes and to ensure that all parties are clear about the terms of the agreement. In chapter 10 the Review recommends that operators should be required to lodge a copy of the scheme's constitution with the ASC.[4] This requirement will mean that a scheme's constitution will have to be in writing.

Covenants and contents

4.4 ***Prescribed covenants.*** The deed for a prescribed interest scheme must include the covenants prescribed by the Corporations Law, or covenants to the same effect. These covenants relate to various things the manager and trustee or representative must do and how they must act. Other recommendations in this report deal in detail with obligations and duties that the law ought to impose on operators of collective investment schemes. They cover such matters as how operators should act and the issue, buy back and redemption of interests, meetings of investors and minimum financial controls. In each case, the Review recommends that these obligations and duties be imposed directly on operators by the Corporations Law. The device of covenants between parties is an unnecessary complication. The obligations that the law imposes should be imposed, and be enforceable, directly. DP 53 proposed that necessary obligations be imposed by legislation rather than be contained in covenants.[5] This proposal was widely supported in submissions as a more direct and expeditious method of prescribing basic obligations.[6] The Review **recommends** that the approach of imposing obligations through prescribed covenants no longer be followed. The prescribed covenant provisions of the Corporations Law and regulations should be repealed. Obligations should be imposed directly, by the law itself. Appendix A shows which of the provisions of the draft legislation in Volume 2 reflect the existing covenants prescribed by the Corporations Law.

4.5 ***Contents of constitution.*** Matters covered by the Corporations Law will be dealt with as direct obligations on scheme operators. The constitution of a collective investment scheme will have to cover other matters. These would include the investment or management powers of the scheme operator, the way unit prices are to be calculated, the basis on which fees are to be charged and other aspects of the relationship between investors and the scheme operator not covered by provisions in the Corporations Law. Most of the matters left to be prescribed by scheme constitutions will be peculiar to each scheme. The provisions of the constitution should be enforceable directly.

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4. As part of the licensing and registration process: see para 10.42.
5. Unless it is inappropriate to do so in respect of specific covenants, in which case they should be deleted: proposal 4.2. The Review notes that the Superannuation Industry (Supervision) Bill 1993 (Cth) has adopted from the Corporations Law the covenants system. The Review does not consider that this is advisable for the same reasons that it considers it inappropriate for collective investment schemes.
6. eg Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992; MLC Investments Limited *Submission* 17 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992.

Presumption of compliance with constitution

4.6 Persons who deal with companies are entitled to assume that the company's constitution has been complied with.[7] This protects them if the company acts beyond its powers. The Review considers that persons dealing with collective investment schemes should have a similar protection.[8] It **recommends** that a person dealing with the operator of a collective investment scheme should be entitled to assume that the scheme's constitution has been complied with.

Scope for standardisation and simplification of scheme constitutions

4.7 There have been suggestions over the years that deeds for prescribed interests schemes, or classes of prescribed interests schemes, ought to be standardised.[9] While attractive in principle, the recommendations in this report make standardisation unnecessary. In any event, it is probably not possible to draft a standard constituting document without constraining schemes to an undesirable extent. The definition of collective investment schemes covers such a wide variety of schemes that a standard document would be difficult to draft and inappropriate in practice, unless it imposed a rigid structure on all schemes. The Review's recommendation to include a number of duties and procedural matters in the Corporations Law (instead of prescribing them by covenant or leaving them to individual schemes) reduces the need for a standard document.

Approval of scheme constitutions

4.8 Under the current law, deeds for prescribed interest schemes must be approved by the ASC.[10] The ASC must grant approval 'unless it is of the opinion that the deed does not comply with the requirements of this Division and of the regulations'.[11] The main purpose of the current approval process is to ensure that the prescribed covenants are included in the deed, either expressly or by reference.[12] The Review's recommendation that the system of prescribed covenants not be continued removes the need for approval. The Review's proposal in DP 53 that constituting documents not have to be approved by the regulator was widely supported.[13] The Review **recommends** that there should be no requirement for the constituting document of a collective investment scheme to be approved by the ASC.

7. Corporations Law s 164.
8. Arthur Robinson & Hedderwicks advocated including provisions to the effect of Corporations Law s 162, 164-6 for collective investment schemes: *Submission* 16 December 1992. Many of the assumptions in s 164(3) will apply to scheme operators which will be required, under the Review's recommendations,to be companies.
9. eg the CSLRC recommended that model provisions for deeds be included in the legislation: CSLRC Report, para 83.
10. Corporations Law s 1065.
11. Corporations Law s 1067(2).
12. The ASC will not rely on s 1069(7) which deems covenants to be contained in the deed if they are not expressly contained in the deed: Policy Statement 23. The deeming provisions will be relied on in relation to deeds in existence before the introduction of s 1069(1). If such a deed is amended, however, the ASC will require it to be amended so as to comply with s 1069.
13. eg Arthur Robinson & Hedderwicks *Submission* 16 December 1992; MLC Investments Limited *Submission* 17 December 1992.

Registering schemes

4.9 Individual collective investment schemes should, nevertheless, be clearly identifiable for regulatory and general information purposes. The Review **recommends** that each scheme should have to be registered by the ASC and given a unique registration number to enable it to be identified. It should be an offence to issue units in a scheme unless the scheme is registered. Registration should not involve an assessment by the ASC of the commercial merits of the scheme. It should be for identification purposes only. A scheme operator should be required to use the registration number of the scheme in all dealings in respect of the scheme, just as companies are now required to use their Australian Company Number in all dealings involving the company. In chapter 10 the Review recommends that the operator of a collective investment scheme should be licensed by the ASC. The application for registration of the scheme should be made at the same time as the operator applies for a licence.[14]

14. A company that already has a licence in respect of one scheme can apply to have its licence endorsed in respect of further schemes: see para 10.56.

5. Disclosure

Introduction

5.1 This chapter makes a number of recommendations to enhance the disclosure practices of operators of collective investment schemes. The recommendations cover disclosure to prospective investors, advertising by operators of collective investment schemes, continuing disclosure to existing investors and disclosure to the ASC and hence the market generally.

The importance of disclosure

Separation of ownership from control

5.2 The separation of ownership and control that characterises many commercial enterprises, including collective investment schemes, makes it important that investors be kept informed regularly by management about the enterprise's financial position and performance. Collective investment schemes are typically characterised by a more significant separation of ownership and control than trading corporations. Investors in collective investment schemes may therefore have an even greater need for information than many company shareholders. Appropriate and timely information can alert both existing and potential investors to significant developments in the performance of the scheme and, possibly, to inefficiency or misconduct on the part of the scheme operator. Information concerning a scheme's activities can also help individuals make decisions about whether an investment in a particular scheme is advantageous in light of the rest of his or her personal asset holdings.

The role of mandatory disclosure requirements

5.3 Some commentators have questioned the value of mandatory disclosure rules, suggesting that market forces will ensure the best disclosure practices.[1] Others consider that mandatory disclosure is necessary to overcome 'market failure' associated with the private production of securities information. The Review has concluded that, without legal intervention to enforce adequate and timely disclosure, insufficient securities information is produced. Mandatory disclosure rules help to

- reduce information inequality between different classes of investors by ensuring that operators give investors all the information that they have that is relevant to assessing the proposed investment
- increase the accountability of scheme operators to investors
- reduce the duplication of search and research costs by investors[2]

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1. eg CJ Stigler 'Public Regulation of the Securities Markets' (1964) 37 *Journal of Business* 117; CJ Benston 'The Value of the SEC's Accounting Disclosure Requirements' (1969) 44 *Accounting Review* 515.
2. Some duplication may be desirable if it helps to ensure the accuracy of securities information.

- increase the accuracy of securities prices and thereby improve the efficiency with which the capital market allocates financial resources among competing investment opportunities.

Mandatory disclosure rules can also reduce significantly the contracting costs incurred by scheme participants. This happens in three ways. First, the legislation provides investors and managers of all schemes with common disclosure rules. This reduces the costs associated with developing rules for new schemes. Secondly, uniform disclosure practices can reduce the uncertainty that investors face in assessing the risks and benefits of different schemes.[3] Finally, the regulator can help ensure that disclosure requirements are complied with. The Review accepts the argument that mandatory disclosure rules are essential on efficiency and equity grounds. The purpose of legal disclosure rules should be to require the scheme operator to disclose to investors and prospective investors all information in the possession of the operator that is relevant to assessing the risks and benefits of investing in the scheme — that is, to reduce the information gap between the operator and the investors.

The importance of comprehensive, comprehensible and consistent requirements

5.4 In ALRC 59 the Review stressed the importance of ensuring that comprehensive, comprehensible and consistent disclosure requirements were imposed on the superannuation industry.[4] These three criteria are equally applicable to information supplied to investors in collective investment schemes even though, unlike superannuation, investment in collective investment schemes is not compulsory. While the variety of existing collective investment schemes makes it harder to design meaningful and consistent disclosure requirements, it is important that different schemes be comparable because they perform essentially the same function.

Advertising collective investment schemes

Misleading advertising prohibited

5.5 *Advertising by prospectus.* DP 53 suggested that it is important to regulate advertising to help ensure that offerors of collective investment schemes do not mislead prospective investors and that information provided is truthful and realistic. Misleading or deceptive conduct in respect of prescribed interest schemes is prohibited by the Corporations Law[5] and, in some cases, by the *Trade Practices Act 1974* (Cth).[6] A false or misleading material statement in, or a material omission from, a prospectus is specifically prohibited by the Corporations Law.[7] Under the Review's proposals, operators of all collective investment schemes will be subject to these provisions of the Corporations Law and provisions of the *Trade Practices Act*

3. JN Gordon 'The Mandatory Structure of Corporate Law' (1989) 89 *Columbia Law Review* 1549.
4. ALRC 59 para 10.7.
5. s 995.
6. The *Trade Practices Act 1974* (Cth) prohibits a corporation, in trade or commerce, from engaging in conduct that is false or deceptive (s 52) or unconscionable (s 51AA, 51AB).
7. s 996.

1974 (Cth). The ASC has the power to issue stop orders in relation to a prospectus. DP 53 suggested that the regulator of collective investment schemes should also have such a power.[8] The Review maintains this view.

5.6 ***Other advertising.*** A prospectus is not the only source of information about a collective investment scheme. Other types of advertising may be used. Pre-prospectus advertising in relation to all kinds of securities is subject to specific controls.[9] Currently, the ASC does not have the power to ban advertisements for prescribed interests. The Review noted in DP 53 that the Life Insurance Commissioner may object to any form of proposal or policy if of the opinion that it is likely to mislead.[10] DP 53 proposed that the ASC should have power to stop the issue or continued use of any form of advertising it considers likely to mislead. It proposed that the law should provide the ASC with a power, similar to that of the Life Insurance Commissioner under the *Life Insurance Act 1945* (Cth) s 77, to require production to the ASC of any advertising matter used, or proposed to be used, by or on behalf of the operator of a collective investment scheme.[11] In addition, it suggested that the law should provide the ASC with power to stop the use, or further use, of the matter as advertising if it is of the opinion that it is likely to mislead or deceive. The proposal received widespread support among respondents.[12] One submission suggested that the ASC should be given standing to make an application (*ex parte* if necessary) for an injunction in relation to advertising material to prevent a breach of the Corporations Law s 995.[13] The ASC already has this power in respect of any contravention of the Corporations Law.[14]

5.7 ***Recommendation.*** The prohibition on misleading and deceptive conduct in relation to collective investment schemes imposed by the Corporations Law s 995 should continue. The Review **recommends** that it should specifically extend to all forms of advertising or disclosure material including writing, films and other media. In conjunction with the ASC's other powers, including its stop order powers,[15] which should not be affected, it would be an effective and direct means of addressing the problem of misleading and deceptive advertising.

Advertisements to identify scheme operator

5.8 Under the Review's recommendations, there will be a single operator for each collective investment scheme. Investors must be aware of the operator's identity. In the case of superannuation, it was considered necessary to require the name of the operator to be prominently displayed on the cover of the member booklet or other offer document. This was seen to be particularly important if a hired investment manager is more widely known than the operator. DP 53

8. Proposal 11.18.
9. Corporations Law s 1025. See also ASC Policy Statement 54.
10. *Life Insurance Act 1945* (Cth) s 77.
11. Proposal 6.3.
12. eg Credit Union Services Corporation *Submission* 27 November 1992; TCA *Submission* 17 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992.
13. Arthur Robinson & Hedderwicks *Submission* 16 December 1992.
14. Corporations Law s 1324.
15. Under the Corporations Law s 1033.

proposed that the law governing collective investment schemes should require prominent display of the name of the scheme operator and that contravention should be an offence.[16] The proposal was widely supported by respondents.[17] The Review therefore **recommends** that the law should provide that the front cover or front page of a prospectus of a collective investment scheme must to display prominently the name of the scheme operator and the registration number of the scheme. It should also provide that advertisements must display the same information.

Initial disclosure by the scheme operator: the prospectus[18]

The need for a prospectus

5.9 The Corporations Law includes an absolute prohibition on offering securities without a prospectus that has been lodged with, and, in certain cases, registered by, the ASC unless the offer is specifically exempted.[19]

The content of prospectuses

5.10 *Corporations Law requirements.* Before the commencement of the Corporations Law, the content of prospectuses was evaluated against a detailed checklist of mandatory requirements.[20] There are now, by contrast, few detailed prescriptions.[21] The Corporations Law imposes a general, non-prescriptive obligation to include all information that investors and their professional advisers would reasonably require, and reasonably expect to find, in the prospectus for the purpose of making an informed assessment of

(a) the assets and liabilities, financial position, profits and losses and prospects of the arrangement, common enterprise, financial or business undertaking, investment contract or scheme; and
(b) the rights attaching to the securities; and
(c) the merits of participating in that arrangement, common enterprise, financial or business undertaking, investment contract or scheme and the extent of the risks involved in the participation.[22]

16. Proposal 6.4.
17. Credit Union Services Corporation *Submission* 27 November 1992; TCA *Submission* 17 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992.
18. There is presently some uncertainty about the role of trustees in the preparation of prospectuses for prescribed interest schemes. In particular, there is doubt whether trustees 'authorise or cause the issue of' prospectuses for prescribed interest schemes for the purposes of the Corporations Law s 1006. If the Review's recommendation that collective investment schemes need only have a single operator is adopted, this issue will not arise.
19. Corporations Law s 1018. Lodgement involves making the document publicly available whereas 'registration suggests a greater degree of regulatory involvement': Securities Information Review Committee *Interim Report* August 1988, 14.
20. Companies Act 1981 and Codes, s 98.
21. They include requirements such as that the prospectus be dated, that the interests of directors and experts be set out and that there be a statement that the prospectus has been lodged with the ASC on a specified date and that the ASC takes no responsibility as to its contents: Corporations Law s 1021.
22. Corporations Law s 1022(1); Corporations Regulations reg 7.12.12.

This obligation places the onus on prospectus issuers to determine what should be included in prospectuses. In doing this regard may be had to the nature of the securities and the kinds of persons likely to buy the securities.[23] For example, if the offer is to existing shareholders of a company regard may be had to any relevant information previously given to them.

5.11 ***Recommendation.*** The question of a general disclosure requirement was considered by the Companies and Securities Advisory Committee in its *Prospectus Law Reform Report*.[24] That report recommended that s 1022 continue. DP 53 suggested that the advantages of the general disclosure requirement[25] outweigh any disadvantages,[26] and proposed that the requirement should continue to apply to prospectuses of collective investment schemes. There was widespread support for retaining s 1022 for collective investment schemes.[27] Submissions indicated that the requirement under s 1022 is now widely understood and prospectus preparers are becoming more comfortable with its application. The Corporations Law s 1022 should continue to apply to collective investment schemes. The Review **recommends,** however, that it should be modified to require prospectus issuers to provide information relevant to the nature of, in addition to the extent of, the risks of participating in the scheme.[28]

Prescribed contents of prospectuses

5.12 ***Proposal.*** While DP 53 did not favour the use of a purely prescriptive approach to the contents of prospectuses, it did suggest that, to provide adequate protection to investors and to enable them to make better comparisons between collective investment schemes, certain information should be required specifically. DP 53 proposed that, in addition to the general disclosure requirement under s 1022, prospectuses should have to set out

23. Corporations Law s 1022(3).
24. Companies and Securities Advisory Committee *Prospectus Law Reform Report* Sydney, 1992.
25. The Advisory Committee report noted these as
    - it is more likely to promote an allocatively efficient capital market
    - it assists in ensuring relevance to investors of information disclosed
    - it reduces the likelihood of important information being omitted
    - it focuses prospectus preparers on the information needs of investors
    - it enables information providers to react to changes in investors' information needs as market conditions change: para 106-7.
26. Noted in the Advisory Committee report as
    - inconsistency and incomparability of reports
    - cost and time involved in prospectus preparation and
    - problems of interpreting the requirement through litigation.
27. Macquarie Investment Management Ltd *Submission* 24 November 1992; IFA *Submission* 1 December 1992; Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992.
28. Currently reg 7.12.12 refers only to the extent of risks involved in scheme participation.

- if investments other than those listed in the prospectus are authorised by the deed or are able to be invested in by the scheme operator — that fact
- if a prospectus suggests that there is a link between the issuer and another institution — full details of that relationship[29]
- the investment performance of the scheme over the previous five years (or over the life of the scheme, if it had not been in existence for five years)
- the amount and nature of any fees and charges the scheme operator proposes to charge against investors' funds.[30]

In suggesting that these matters should have to be disclosed in a prospectus, the Review was in no way advocating a return to the detailed disclosure requirements and vetting practices associated with the various Companies Codes. Nor was it suggesting that adherence to these requirements would absolve the operator of a collective investment scheme from its responsibilities under the general disclosure regime. The Review called for comment on whether any additional matters should be prescribed.

5.13 *Submissions.* The majority of submissions that commented on the proposal supported some prescribed contents for prospectuses.[31] Nevertheless, some opposed prescribing the contents of prospectuses.[32] Their main concern was the risk of reverting to a 'check-list' approach, such as existed before the Corporations Law.[33] On the question what matters should have to be disclosed, it was suggested that it may be impractical to require the disclosure of the amount of fees and charges proposed to be levied by the operator.[34] The amount of fees may, for instance, be based upon asset size at a future time. Other matters suggested as ones that should be disclosed included

- the manager's name and address, qualifications and experience
- key features of the collective investment scheme
- an independent expert's report on financial information.[35]

5.14 *Recommendation.* While a return to lengthy and detailed check-lists would be highly undesirable, the Review has concluded that the law should prescribe specific matters that all prospectuses issued in relation to collective investment schemes should set out. It **recommends** that the following matters should have to be included in each prospectus:

29. The Martin Committee in its review of the banking industry recommended that there be prominent disclosure in prospectuses that subsidiaries are in no way guaranteed by the parent bank: Martin Report recommendation 37, para 14.39.
30. Proposal 6.2.
31. eg National Mutual *Submission* 3 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992.
32. Macquarie Investment Management Ltd *Submission* 24 November 1992; IFA *Submission* 1 December 1992; MLC Investments Ltd *Submission* 17 December 1992.
33. One submission suggested that an industry code should be set up to determine what information should be disclosed for specific schemes. The industry body could inform the regulator if it believed there was a breach of its code. The regulator could then issue a stop order on the offending prospectus: Macquarie Investment Management Ltd *Submission* 24 November 1992.
34. National Mutual *Submission* 3 December 1992.
35. ASCPA & ICAA *Submission* 15 February 1993.

- all the kinds of investments authorised by the scheme's constitution
- how the operator's fees and charges are to be worked out
- if the prospectus suggests that another entity will or may assume a liability in relation to the scheme, for example, by way of guarantee — the circumstances in which the liability will arise
- the scheme's management expense ratio over the previous five years (or for the years the scheme has been in existence if it is less than five years old), that is, the ratio of total fees and expenses to the value of the assets in the scheme[36]
- details of the scheme's internal dispute resolution procedures.

The s 1022 requirement should still apply.

Should prospectuses have to be lodged?

5.15 ***Present law.*** Prospectuses must be lodged with the ASC.[37] There are two main exceptions:

- offers of securities already issued and listed on the ASX before the commencement of the Corporations Law[38]
- excluded offers, invitations and issues.[39]

One of the principal exemptions for shares and debentures (known as the limited offers exception) is where

- the securities are issued or allotted to a person as a result of the acceptance of
  - an offer made personally to that person or
  - an offer made by that person pursuant to an invitation issued personally to that person and
- either
  - no other securities of the same class are issued or allotted at the same time, or have been issued or allotted in the preceding 12 months, to any other person or
  - that person, and any other person or persons to whom securities of the same class are issued or allotted at the same time or have been issued or allotted in the preceding 12 months, do not together exceed 20 in number.[40]

A similar exemption exists for offers or invitations of shares or debentures made or issued personally to a person.[41]

36. The proposal in DP 53 that the investment performance of the scheme over the previous five years be disclosed has been abandoned as such information could, in some circumstances, give a misleading picture of the future prospects of the scheme.
37. Corporations Law s 1018.
38. Corporations Law s 1018(2).
39. Corporations Law s 1017.
40. Corporations Law s 66(2)(d). In determining whether this exemption is applicable, the relative investment expertise and the wealth of the offerees or invitees is irrelevant.
41. Corporations Law s 66(3)(d).

5.16 *Applying exemptions to collective investment schemes.* The Corporations Bill tabled in federal Parliament in May 1988 provided for both prescribed interest schemes and share capital companies to be exempted from the requirement to lodge a prospectus in cases constituting 'limited offers'. However, following the report of the Edwards Committee,[42] the exemption was not extended to prescribed interest schemes. In principle, there appear to be no greater opportunities for abuse of the limited offer provisions by prescribed interest schemes than by share capital companies. The rationale put forward by the Edwards Committee for not excluding such offers is unclear. If investors in small share issues do not need the information provided in a prospectus, there is no reason why investors in small collective investment schemes need the information provided in a prospectus. Perhaps individuals who invest directly in shares are more financially sophisticated than investors in other collective investment schemes and therefore are assumed to require less information to enable them to make sound investment decisions. DP 53 sought comments on whether an exemption from the prospectus requirements should be available for limited offers of interests in a collective investment scheme.[43]

5.17 *Submissions.* Submissions generally supported the view that a limited offers exemption should be available for collective investment schemes.[44] One submission argued that

> [t]he preparation and lodgement of a prospectus is an expensive process which would make many smaller offers uncommercial. Where a prospectus is not strictly necessary, the legislation should provide relief from that expensive obligation.[45]

Another stated, however, that:

> We cannot envisage a situation where an exemption to lodge a prospectus ought to occur for limited offers of collective investment schemes. The purpose of collective investment schemes is, by nature, 'collective' and generally available. Accordingly, an exemption should not be available under any circumstances.[46]

5.18 *Recommendation.* The Review **recommends** that an automatic exemption from the prospectus requirements should not be available for limited offers of collective investment schemes. Such an exemption may be the subject of abuse by unscrupulous promoters offering many small schemes. Under the new regime the ASC will have a general power to exempt a scheme operator from a requirement of the law if it is satisfied that the extent of any loss in investor protection resulting from the exemption would not be significant. This discretionary power, together with the existing prospectus exemptions, is sufficient.[47]

42. Joint Select Committee on Corporations Legislation *Report* AGPS Canberra 1989.
43. Issue 6B.
44. eg Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992 (for offers of up to 15 people).
45. Arthur Robinson & Hedderwicks *Submission* 16 December 1992.
46. Hall Chadwick *Submission* 21 December 1992.
47. 'Small schemes', ie, those that cannot have more than $100 000 in subscriptions, will be totally exempt from the collective investment provisions of the Corporations Law: see para 3.29.

Should prospectuses have to be registered?

5.19 Most prospectuses have to be registered by the ASC.[48] If a prospectus is `registrable', the ASC must register it within 14 days of lodgement unless it appears to the ASC that the prospectus does not comply with the requirements of the Corporations Law or the ASC is of the opinion that the prospectus contains a false or misleading statement or that there is a material omission from the prospectus.[49] A recent report by the ASC recommended the abolition of existing prospectus registration procedures on the grounds that

- the require considerable resources
- the present 14 day registration period is not long enough to conduct an extensive examination of prospectuses, yet naive investors may believe that such an examination has been undertaken
- the registration period can provide timing problems for prospectus issuers, particularly in the case of international offerings.[50]

The Review doubts that the present registration process provides significant additional investor protection. Vetting of prospectuses by the ASC after they have been lodged, and the use of the ACS's stop order power, would provide more protection. DP 53 sought comment on whether collective investment scheme prospectuses should have to be registered by the regulator.[51] The vast majority of submissions suggested that registration requirements be abolished.[52] The Review **recommends** that collective investment scheme prospectuses should not have to be registered. Lodgement with the ASC will suffice.

Maximum life of prospectuses

5.20 ***Introduction.*** Generally, a prospectus has a life of six months from its date of issue.[53] While the maximum life of certain prospectuses may be extended, a supplementary prospectus must be issued in the event of a significant change.[54]

48. Unless an offer relates to a class of shares or debentures already listed on the ASX or is an offer or issue to existing shareholders of a company, to an 'exempt recipient' or to the employees of a listed corporation: Corporations Law s 1017A(3), (4). One result of these exemptions is that unit trusts listed on the ASX must register their prospectuses whereas companies listed on the ASX need only lodge theirs. Also, offers of unlisted prescribed interests to existing holders under the same approved deed must be registered whereas offers of unlisted shares to existing holders do not have to be.
49. Corporations Law s 1020A; Corporations Regulations reg 7.12.08.
50. ASC *Prospectus Law Reform* August 1992, para 23.
51. Issue 6C.
52. Macquarie Investment Management Ltd *Submission* 24 November 1992; IFA *Submission* 1 December 1992; National Mutual *Submission* 3 December 1992; Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; TCA *Submission* 17 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992. An exception was County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
53. Corporations Law s 1040. Certain prescribed interest schemes (cash management trusts and mortgage trusts) can offer interests under a 12 month prospectus, provided the ASC is satisfied that the information in the prospectus is unlikely to change over the life of the prospectus (demonstrated, for example, by past stability) and there is adequate monitoring of the issuer by an appropriate industry body during the life of a prospectus: ASC Policy Statement 18 para 45. This was also the policy of the NCSC: NCSC Policy Statement 158.
54. Corporations Law s 1024.

While DP 53 was being written, both the federal Government and the ASC were reviewing the policy on extended life prospectuses. DP 53 sought comments on what the maximum life of a collective investment scheme prospectus should be.[55] There was considerable support for a maximum time period of one year.[56] It was argued that keeping a six month life for prospectuses is costly for investors without adding materially to investor protection. Several respondents claimed that the requirement under the Corporations Law for a supplementary prospectus to be issued whenever there is a significant change affecting any matter contained in the prospectus, or significant new matters which would affect the prospectus reduces the need for a six month maximum life.[57]

5.21 ***Recommendation.*** As part of an enhanced disclosure regime, the Corporate Law Reform Bill (No 2) 1992 [1993] (Cth) proposes to extend to 12 months the life of a prospectus relating to the securities of an entity that has

- been a 'disclosing entity' for 12 months or
- on two occasions in the previous 15 months lodged primary prospectuses with the ASC under the Corporations Law s 1018.

The following entities (among others) are disclosing entities under the Bill and consequently are to be subject to the enhanced disclosure requirements:

- entities and prescribed interest schemes listed on the ASX or other specified markets
- entities and prescribed interest schemes that raise funds in circumstances where a prospectus must be lodged with the ASC
- entities and prescribed interest schemes which offer securities other than debentures as consideration for an acquisition under a takeover scheme
- other prescribed interest schemes designated by regulation.[58]

The Review supports the principles underlying the proposals in the Bill subject to one modification. It considers that the life of prospectuses should be 13 months, rather than 12. A 12 month limit would require the prospectus issuer to have a new prospectus issued slightly before the expiration of the 12 month period, to ensure there is always a current prospectus. The issue dates for prospectuses will, as a result, become slightly earlier each year.The Review **recommends**, therefore, that the Corporate Law Reform (No 2) Bill 1992 [1993] (Cth) should provide for 13 month prospectuses. The Review recognises, however, that the life of prospectuses should

55. Issue 6A.
56. eg Macquarie Investment Management Ltd *Submission* 24 November 1992; IFA *Submission* 1 December 1992; National Mutual *Submission* 3 December 1992; Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; TCA *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992. Those in support of keeping the six month life span for collective investment prospectuses included ASCPA & ICAA *Submission* 15 February 1993.
57. BT *Submission* 15 December 1992; MLC Investments Limited *Submission* 17 December 1992; Lend Lease Property Funds Management *Submission* 18 December 1992; TCA *Submission* 17 December 1992.
58. Corporations Law proposed new Pt 1.2 Div 3A.

be the same for all disclosing entities. Accordingly, it considers that, whether or not this recommendation is adopted, whatever prospectus life is provided for when this aspect of the Bill is enacted should apply to collective investment schemes.[59]

Periodic and continuing disclosure by the scheme operator

Annual reports of collective investment schemes

5.22 *The need for a report.* The requirement for a company to report annually to shareholders on its activities has long been accepted as fundamental to ensuring the accountability of directors for their management. The law generally does not yet require such a report to the investors in a collective investment scheme.[60] Only a 'statement of accounts' and a copy of the auditor's report on those accounts must be furnished.[61] However, like shareholders, investors in collective investment schemes have entrusted others with the management of their investment and they bear the investment risk.

5.23 *Recent moves by the ASC.* Disclosure requirements have been under scrutiny following the unlisted property trust crisis in mid 1991. A recent amendment to the regulations governing property trusts includes a requirement that their accounts include

> all the applicable information that would be required to be shown in the accounts of the trust by the Corporations Law if the trust were a company to which the Law applied.[62]

The ASC also recommended that the Corporations Law Pt 3.6, which covers accounts and reports by directors, should apply to all prescribed interest schemes that are required to have an approved deed under Corporations Law s 1066.[63] The approved deed test is designed to catch only 'public schemes'. The ASC suggested that there are two main benefits in this proposal:

- it will ensure that such accounts are of acceptable quality
- the accounts of the prescribed interest schemes can be used to compare the financial position of one scheme with another and with companies.

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59. The Review recommends elsewhere in this report that all collective investment schemes should be subject to the enhanced disclosure regime proposed in the Corporate Law Reform (No 2) Bill: see para 5.35.
60. Except in the case of property trusts, where the management company must report to the trustee not later than two months after the end of the financial year and give the report to the interest holders with the statement of accounts: Corporations Regulations reg 7.12.15(7)(a). Reg 7.12.15(7)(b) sets out the things that a management company must include in such a report.
61. Corporations Law s 1069(1)(f). The section also provides that the trustee or representative must send investors a statement that describes the buy-back arrangements in effect and expresses whether, in its opinion, those arrangements are adequate.
62. Corporations Regulations reg 7.12.15 (5)(p)(x).
63. ASC *Enhanced Statutory Disclosure System: A Response to the Companies and Securities Advisory Committee Report* February 1992, para 166. The ASC also recommended a requirement for accounts of unit trusts to be compiled on the basis of approved (applicable) accounting standards: submission by the ASC to the Inquiry into Corporate Practices and the Rights of Shareholders by the House of Representative Standing Committee on Legal and Constitutional Affairs, December 1990, 98.

The effect of this proposal, in broad terms, would be that the operator of each collective investment scheme would have to supply to each investor in the scheme an audited profit and loss statement and balance sheet. The financial statements would be required to comply with approved accounting standards and other prescribed standards[64] and to provide a true and fair view of the scheme's profit and loss and state of affairs.[65] In addition, the operator would be required to prepare the equivalent of a directors' report and statement, for inclusion in the annual report.

5.24 ***DP 53 proposal and submissions.*** DP 53 proposed that operators of collective investment schemes should be required to provide to investors, with the accounts of the scheme, an annual report on the activities of the scheme in accordance with Pt 3.6 of the Corporations Law.[66] It acknowledged that an examination of the cost and benefits of complying with specific accounting standards (such as the capitalisation of financial leases and the calculation of distributable income) may be necessary in respect of collective investment schemes. It added that this matter could be referred to the Australian Accounting Research Foundation.[67] There was wide support for the proposal.[68] One submission suggested that investors in a collective investment scheme should be able to elect not to receive annual reports automatically.[69] Another suggested that the operator should be under an obligation to distribute copies only to investors who request them.[70]

5.25 ***Recommendation.*** The Review **recommends** that each scheme operator should be required to give investors in those schemes for which it is responsible an annual audited report on scheme activities. In accordance with the Corporations Law Pt 3.6 this should occur automatically rather than upon the request of single investors. The general provision for the ASC to grant exemptions will apply to the reporting requirements.[71]

Additional prescriptions

5.26 ***Proposal.*** DP 53 proposed that the following information should have to be included in the annual report of a collective investment scheme:

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64. Such as the Corporations Regulations Schedule 5.
65. There is evidence of considerable diversity in current reporting practices of unit trusts: see, eg, Price Waterhouse *Unit Trusts in Australia: A Survey of Accounting Policies* August 1991; B Howieson 'Beyond Redemption: How Property Trusts Do Their Sums' 1992 (May) *Australian Accounting Review* 21.
66. Proposal 6.5.
67. The Australian Accounting Research Foundation is currently considering differential reporting requirements for various organisational forms, but it is understood that this analysis does not extend to prescribed interest schemes.
68. eg Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; TCA *Submission* 17 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992.
69. National Mutual *Submission* 3 December 1992.
70. MLC Investments Limited *Submission* 17 December 1992.
71. See para 3.30.

- the percentage change in the value of units during the last reporting period
- the unit price at the beginning and end of the reporting period
- as an indication of the volatility of the investment, the highest, lowest, mean and median values of units during the last reporting period
- the size and nature of each investment that constitutes more than 5% of the funds of the scheme
- the investment policy of the scheme and its performance against that policy.

It was suggested that annual reports should also include details of any notices lodged with the ASC as part of a continuous disclosure regime.[72] There was general support for the proposal among respondents,[73] although one submission maintained that scheme operators should not be compelled to supply the information items proposed, merely encouraged to do so.

> It is considered that until more prescriptive disclosures are introduced for companies, requiring additional disclosures for collective investment schemes is premature.[74]

Other respondents considered the third point, relating to the volatility of investments, inappropriate and potentially misleading to investors.

5.27 ***Recommendation.*** The Review agrees with the majority of submissions and accepts the argument on the issue of the volatility of investments. It **recommends** that annual reports of all collective investment schemes should have to include

- the unit price at the start and end of the reporting period, and the percentage change in price between the start and end of the period
- if the scheme is unlisted, an explanation of how the price of interests in the scheme is calculated
- the highest and lowest values of units during the last reporting period
- the size and nature of each investment that constitutes more than 5% of the funds of the scheme
- the investment policy of the scheme and its performance against that policy
- any significant changes to the scheme's state of affairs, including any material change in investment policy, in the reporting period
- details of any notices lodged with the ASC as part of the proposed enhanced disclosure regime
- the scheme's management expense ratio over the previous five years (or for the years the scheme has been in existence if it is less than five years old), that is, the ratio of total fees and expenses to the value of the assets in the scheme
- details of any purchase by the operator of either existing or new interests in the scheme[75]

72. Proposal 6.6.
73. Macquarie Investment Management Ltd *Submission* 24 November 1992 (supports only the first 3 elements of the original proposal).
74. ASCPA & ICAA *Submission* 15 February 1993.
75. This information should also be disclosed in half yearly reports.

- the procedure by which investors may apply for redemption of their interests, whether there is any obligation on the scheme operator to make redemption offers, and if so, the nature of that obligation[76]
- in relation to redemption opportunities provided to investors in the previous 2 years, how many opportunities were provided and, where redemption requests were not met in full, what proportion of the application was met[77]
- details of the scheme's internal dispute resolution procedures
- details of any change of directors of the scheme operator[78]
- the relevant assumptions and discount rates used in valuations of the assets of the scheme, and the other instructions given to valuers[79]
- a copy of the certificate prepared by an external auditor stating that, in the auditor's opinion, the operator is giving effect to the compliance measures imposed by the Commission as a condition of the operator's licence[80]
- the total number of voting interests in the scheme as at the date of the report.[81]

Accounts of scheme operators

5.28 It was suggested in consultations before DP 53 was published that the operator of a collective investment scheme should have to distribute a copy of its own accounts to investors in the scheme. The Review considered that such a requirement would impose unwarranted costs on operators. It proposed that the operator of a collective investment scheme should be required to lodge a set of its accounts with the ASC each year and to make the most recent published accounts available, upon request, to individual investors in the collective investment scheme or schemes it operates.[82] There was widespread support in submissions for the proposal.[83] The Review **recommends** that scheme operators should be required to make their annual audited accounts available, upon request, to investors in schemes for which they are responsible. Operators should be entitled to charge a reasonable fee to investors who request a copy of the accounts.[84]

Interim reports of collective investment schemes

5.29 ***Proposal by the Advisory Committee.*** There is no general requirement under the Corporations Law for companies or trusts to lodge or prepare interim financial statements. As part of its review of the disclosure practices of companies

76. See para 7.21.
77. In ch 7 the Review makes recommendations about the circumstances, and way, in which a scheme operator may offer to redeem scheme interests: see para 7.21.
78. See para 11.9.
79. See para 6.15.
80. See para 6.17.
81. See para 11.12.
82. DP 53 proposal 6.7. As scheme operators will, under the Review's recommendations, have to be incorporated (see para 10.2) they will, unless exempted, have to lodge accounts with the ASC.
83. Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; TCA *Submission* 17 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992; ASCPA & ICAA *Submission* 15 February 1993.
84. ASCPA & ICAA *Submission* 15 February 1993 argued that the accounts should be available without charge.

and prescribed interest schemes, the Advisory Committee recommended that all prescribed interest schemes with total assets in excess of $10m should lodge half yearly reports with the ASC within 75 days after their fiscal half year end.[85] The Committee proposed that such reports should contain at least a profit and loss statement, a balance sheet and a qualitative assessment by directors of half yearly results. The ASC endorsed the proposal for half yearly reports.[86] Furthermore, it agreed with the Advisory Committee that half yearly reports should only have to be lodged, not distributed to investors. However, the ASC maintained that the requirement should be limited to prescribed interest schemes that are required to have an approved deed.[87] It has been estimated that the adoption of either the $10m or the 'approved deed' test would directly affect approximately 2500 prescribed interest schemes.[88]

5.30 ***DP 53 proposal and submissions.*** The Review strongly supports requirements for comprehensive and timely disclosure. The reports by the Advisory Committee and the ASC demonstrate the need for half yearly reports by operators of collective investment schemes. DP 53 proposed that the operator of a collective investment scheme should be required to produce a half yearly report on the financial position and performance of each collective investment scheme for which it is responsible within, say, 75 days after the end of the fiscal half year.[89] It suggested that these reports should be placed on the ASC's public database to allow investors ready access to them and, as with annual reports, that they include certain prescribed information.[90] There was considerable support for the proposal.[91] Some submissions suggested modifications. One suggested that half-yearly reports should only have to be prepared following a request by investors.[92] Another suggested that investors should only receive a report on fund performance each six months, rather than a complete set of fund accounts.[93]

5.31 ***Recommendation.*** It was noted in DP 53 that the federal Government intended to introduce a half-yearly reporting requirement for certain prescribed interest schemes. The Review supports the principles underlying measures contained in the Corporate Law Reform Bill (No 2) 1992 [1993] (Cth) concerning interim reports. It **recommends** that they be adopted for collective investment schemes. This will include any significant changes in a scheme's state of affairs.[94] The Review also **recommends** that half yearly reports should include details of any change of directors of the scheme operator,[95] any purchase of new or existing interests in the scheme by the scheme operator and details about redemption or

85. Advisory Committee *Report on an Enhanced Statutory Disclosure System* Sydney 1991.
86. ASC *Enhanced Statutory Disclosure System: A Response to the Companies and Securities Advisory Committee Report* Sydney, 1992.
87. id para 86.
88. id Appendix 2.
89. Proposal 6.8.
90. Such as that set out in DP 53 proposal 6.2.
91. eg TCA *Submission* 17 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992; ASCPA & ICAA *Submission* 15 February 1993.
92. National Mutual *Submission* 3 December 1992.
93. Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992.
94. Corporate Law Reform Bill (No 2) 1992 [1993] (Cth) s 304(3B).
95. See para 11.9.

buy back opportunities and any use of the pro-rata mechanism in the previous six months. Half yearly reports should be lodged with the ASC but need not be circulated to members.

5.32 ***Accounting standards for half yearly reports.*** DP 53 sought comment on which accounting standards should be imposed on half yearly reports of collective investment schemes.[96] Few comments were received on this matter. It would require expert study. The Review **recommends** that the Australian Accounting Standards Board should examine

- which accounting standards should apply to half yearly reports of collective investment schemes
- whether an accounting standard should be developed for collective investment schemes and the nature of any such standard.

Continuing disclosure by scheme operators

5.33 ***No general obligation.*** At present there is no general statutory obligation on companies or prescribed interest schemes to disclose material matters in a timely fashion. However, where a prospectus has been lodged and the issue is still 'open', the person who lodged the prospectus must, when a 'significant' change or new matter occurs, lodge a supplementary prospectus containing particulars of the change or new matter.[97] Furthermore, companies and trusts listed on the ASX are required to make timely disclosures of material matters to the ASX.[98]

5.34 ***Recent initiatives.*** The Corporate Law Reform Bill (No 2) 1992 [1993] (Cth) sets out continuous disclosure obligations in a proposed new Pt 7.12A of the Corporations Law. These obligations are intended to apply to certain types of prescribed interest schemes.[99] Under the proposed law, management companies will be required to notify the ASC as soon as practicable, and in any event within three days, of a 'notifiable event'. A notifiable event is defined as an event or change in circumstances about which investors and their professional advisers would reasonably require information for the purpose of making an informed assessment of

- the assets and liabilities, financial position, profits and losses, and prospects of the disclosing entity
- the rights attaching to the securities in relation to the disclosing entity
- the merits of participating in the undertaking and the extent of risk involved in the participation.

It is proposed that the disclosure requirements be subject to a confidentiality exception so that information which would be likely to result in unreasonable prejudice to the disclosing entity need not be disclosed. This exception, however, would lapse where the information ceased to be likely to result in unreasonable

96. Issue 6F.
97. Corporations Law s 1024.
98. ASX listing rule 3A(1).
99. See the definition of disclosing entity in para 5.21.

prejudice. Once this occurred, the disclosing entity would have to notify the ASC as soon as practicable or, in any event, within three business days. A management company knowingly or recklessly contravening the disclosure requirements would be guilty of a criminal offence. Civil liability would arise where an investor suffered loss as a result of a disclosing company's failure to comply with the disclosure requirements. The investor could recover the loss suffered from the disclosing entity or from any person involved in the contravention, whether or not those persons were convicted of an offence. It would be a defence to a civil action if

- the disclosing entity was not aware of the information and
- no compliance system which the disclosing entity could reasonably be expected to have could reasonably be expected to have resulted in the information being disclosed.

5.35 ***Recommendation.*** The measures outlined above largely implement recommendations made by the Advisory Committee in its *Report on an Enhanced Statutory Disclosure System* (1991). DP 53 supported the principles in the Advisory Committee report, provisionally proposing that operators of collective investment schemes be required to notify the ASC on a continuing basis of any material change (as defined by the Advisory Committee) within, say, 24 hours after the occurrence of the change.[100] There was strong support for continuous disclosure principles to be applied to collective investment schemes,[101] although one submission suggested that such an obligation should only be applied at this stage to listed entities.[102] The Review has concluded that continuous disclosure should apply to unlisted as well as listed schemes. The information about unlisted schemes disclosed by operators can be assessed by investment advisers who can disseminate the information, and their assessment of its implications for investors, through investment magazines, newsletters and in other ways. Furthermore, an investment in an unlisted collective investment scheme may be only one part of an investor's investment portfolio. It is important that he or she has as much up to date information as possible about all of his or her investments. Requiring unlisted as well as listed collective investment schemes to be subject to enhanced disclosure will help ensure this. Enhanced disclosure will help to enable investors to decide, on the basis of up-to-date information, whether to remain in a scheme or withdraw from it. The Review considers that the measures proposed in the Corporate Law Reform Bill (No 2) 1992 [1993] (Cth) for continuous disclosure by companies should also apply to listed and unlisted collective investment schemes and **recommends** accordingly.

Plain language

5.36 The Review recommended in ALRC 59 that the law should require all documents issued to members or prospective members by the trustee of a superannuation scheme to be written in clear and simple language.[103] Failure to

100. Proposal 6.9.
101. eg Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; TCA *Submission* 17 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992.
102. ASCPA & ICAA *Submission* 15 February 1993.
103. ALRC 59 recommendation 10.3.

comply was not to be an offence but the regulator would be able to give a written direction to the trustee not to issue a particular document, or to take reasonable steps to recall it from circulation, on the grounds that it is not written in clear and simple language. DP 53 proposed that all disclosure obligations of collective investment schemes be subject to a similar 'plain language' requirement.[104] There was general agreement in submissions that collective investment schemes and their operators should use plain language in giving information to investors.[105] There were concerns, however, that a statutory requirement to that effect would be difficult to police. It was also suggested that existing remedies for misleading statements may be enough.[106] The Review accepts that such a requirement would be, in effect, unenforceable. It also agrees that, if a lack of plain language makes a statement misleading or deceptive, remedies are already available. The Review encourages scheme operators to ensure that all disclosure to investors and prospective investors is in plain language. The Corporations Law, however, should not impose a requirement to this effect.

104. Proposal 6.10.
105. eg Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; TCA *Submission* 17 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992.
106. Arthur Robinson & Hedderwicks *Submission* 16 December 1992.

6. Financial controls on collective investment schemes

Introduction

6.1 Prescribed interest schemes are not subject to significant financial controls or strict prudential supervision. This chapter considers what financial controls on collective investment schemes are necessary to provide investors with appropriate protection against the institution or compliance risks associated with those schemes.[1]

Liquidity controls

Controls of general application

6.2 Only one financial restriction applies generally to prescribed interest schemes: holders of dealers licences must usually hold at all times surplus liquid funds of $50 000 (or net tangible assets of $20 000) or 5% of adjusted liabilities.[2] Other existing controls are the result of either institutional regulation or, in the case of unlisted property trusts, special circumstances. The lack of financial controls on prescribed interest schemes reflects the fact that investment risk in such schemes is borne by investors, not by the scheme operator.

Liquidity controls on unlisted property trusts

6.3 The collapse of the property market resulted in the introduction of financial controls for property trusts. A property trust is defined in the Corporations Law to be a trust where at least 20% by value of the trust property is real property or that is promoted as a trust where at least 20% by value of the trust property is to be real property.[3] The manager of an unlisted property trust must maintain the combined liquidity of the trust at 15% of the trust's assets value, calculated on the basis of a rolling three month average. The combined liquidity of the trust is the liquidity of the trust plus an amount calculated with reference to the management company's liquidity, its assets and the net tangible assets of the trust.[4] The increased liquidity requirement is designed

> to ensure that buy-back and redemption requests may be met when due for payment.[5]

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1. For a discussion of the kinds of risks collective investment schemes face see ch 2.
2. NCSC Release 333, adopted by the ASC.
3. Corporations Law s 1076A.
4. Corporations Regulations reg 7.12.15A.
5. ASC Policy Statement 16 para 15.

Proposal and submissions

6.4 DP 53 proposed that operators of collective investment schemes that offer to redeem investments within seven days should have to ensure that the scheme has either a prescribed percentage of funds, for example 5% of adjusted liabilities, in cash or an equivalent amount in lines of credit with a deposit taking institution.[6] It also proposed that operators of 'illiquid' collective investment schemes should be required to keep a fixed proportion of possible redemptions, say 50% calculated over a three month period, in liquid funds.[7] The rationale for the proposal was to ensure that, in the case of schemes offering payment of redemption requests within seven days, that is, 'liquid' schemes, schemes that experienced delays or difficulties in selling 'liquid' assets would still be able to pay out investors on time, thereby maintaining investor confidence in the ability of schemes to pay them out on time.[8] In the case of illiquid schemes the rationale for the proposal was to assist operators of such schemes to manage their cash flows.[9] Few submissions supported the proposal for a liquid assets requirement for 'liquid' schemes.[10] Most were concerned that requiring these schemes to maintain a level of liquid assets at all times may have the effect of making those assets the most illiquid of the scheme's assets because they would not be able to be used. There was also evidence of an assumption that 'liquid' schemes by definition cannot have a liquidity problem.[11] There was more support for a liquidity requirement for 'illiquid' schemes, but some considered it too prescriptive.[12] Submissions favoured making the scheme operator responsible for matching liquidity and investor redemption intentions as revealed by redemption notices.[13] One submission suggested no controls on liquidity were required if the Review's proposals 8.2 and 8.3 were adopted.[14]

Recommendation

6.5 Many collective investment schemes have been marketed to investors as a form of savings they can access relatively easily. The ability of schemes to meet redemption requests, therefore, has been essential for investor confidence. It is difficult to legislate to ensure liquidity by prescribing a minimum liquidity standard. Operators need to monitor their likely cash flow needs rather than simply meet a legislated minimum liquidity requirement. The Review does not need to recommend a minimum liquidity requirement for any schemes. Fully liquid schemes, by their very nature, will always have liquid assets available to

6. Proposal 9.1. Under DP 53 proposal 8.2 only 'liquid' schemes would be able to offer redemption at call.
7. Proposal 9.1.
8. DP 53 para 9.7.
9. DP 53 para 9.8.
10. Those that did included T Valentine *Submission* 5 November 1992; TCA *Submission* 17 December 1992; Attorney-General's Department *Submission* 21 December 1992.
11. eg ANZ Funds Management *Submission* 21 December 1992.
12. St George Funds Manager Limited *Submission* 18 December 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
13. IFA *Submission* 1 December 1992; BT *Submission* 15 December 1992.
14. Arthur Robinson & Hedderwicks *Submission* 16 December 1992. These proposals dealt with prescribed liquidity controls for schemes offering redemption at call or and fixed term investments.

meet redemption requests. Other schemes will not be required to meet redemption requests beyond the capacity of the scheme, at any particular time, to pay.[15] Accordingly, the Review **recommends** that the Corporations Law should not prescribe a minimum liquidity requirement.

Borrowing controls

Current controls

6.6 Before the collapse of the property market, there were no controls on gearing by prescribed interest schemes. Several property trusts that experienced problems in 1991 were highly geared. As part of its response to these problems, the ASC proposed that unlisted property trusts be subject to a borrowing limit of 20% of the gross assets of the fund.[16] Trustee companies in most States are subject to controls on the amount they can borrow.[17]

Should borrowing be controlled?

6.7 *The case for borrowing controls.* The case for borrowing controls on collective investment schemes rests on the argument that collective investment schemes are investment schemes, not gearing arrangements. It may also be argued that most investors make their decision to invest in a particular scheme on the basis of the anticipated rate of return and the kind of assets to be invested in by the scheme. The ability of the scheme to borrow, or its level of borrowing, is not generally a key factor in their decision. Nor do all investors appreciate the implications for their investment of a scheme's decision to borrow. The difficulties experienced by the more highly geared property trusts also suggest that market disciplines, which should prevent collective investment schemes from borrowing more than they can afford, are not sufficiently robust to be relied on. This element of market failure would not ordinarily be cause for comment. However, in this instance it contributed to the federal Government becoming involved in arranging a solution to the property trust industry's problems. Collective investment schemes in several overseas jurisdictions are subject to borrowing restrictions. The UCITS directive, for example, restricts borrowing to 10% of the value of a scheme's assets. In Hong Kong schemes may borrow up to 25% of the value of their assets. A number of responses to IP 10 suggested that a gearing limit should be imposed on collective investment schemes.[18]

6.8 *The case against borrowing controls.* Controlling the ability of scheme operators to borrow against the scheme assets could limit the kinds of schemes available to investors. There will be some projects, for example private infrastructure projects such as power stations, that would not be able to be undertaken by a

15. See para 7.21.
16. ASC Policy Statement 16 para 17.
17. In NSW and WA the borrowing limit is fixed such that total liabilities must not exceed assets by more than 3:1: *Trustee Companies Act 1964* (NSW) s 29(2), *Trustee Companies Act 1987* (WA) s 29(2). In Tasmania and Victoria the total assets to liabilities ratio cannot exceed 1:1: *Trustee Companies Act 1953* (Tas) s 17A(2), *Trustee Companies Act 1984* (Vic) s 31(2).
18. eg MLC Investments Limited *Submission* 22 November 1991; IFA *Submission* 8 April 1992.

collective investment scheme unless the scheme could borrow. Such a restriction would also be inconsistent with the private nature of collective investment schemes. The proponents of this view suggest that, instead of restricting borrowing, the law should require the borrowing policy of each scheme to be disclosed. Investors who do not wish to invest in a geared scheme can invest accordingly.[19]

Proposal and submissions

6.9 DP 53 accepted that, on balance, the arguments in favour of a limit on borrowings by collective investment schemes were more persuasive than those against borrowing controls. It proposed that collective investment schemes should be prohibited from borrowing funds in excess of 10% of the gross value of the assets of the scheme unless the borrowing was to provide liquidity to the scheme to enable the scheme to meet redemption requests.[20] A number of submissions supported a comprehensive restriction on borrowings.[21] Others argued that the restriction may not be appropriate for all schemes.[22] In particular there was concern that such control would stifle the development of schemes for financing the construction of infrastructure.

> The proposal to prohibit borrowing funds in excess of 10% of the gross value of the assets of collective investment schemes will effectively eliminate the use of limited partnerships and unit trusts as suitable structures for private infrastructure projects and property syndicates.[23]

Recommendation

6.10 While for the many large mass-marketed collective investment schemes a limit on borrowings is appropriate, there are some kinds of collective investment schemes, such as infrastructure projects, for which a borrowing limit would be entirely inappropriate. The operator of such a scheme should be permitted to borrow on behalf of the scheme an amount in excess of 10% of the gross assets of the scheme. It should be required, however, to indicate clearly that the scheme is a geared scheme. The Review therefore **recommends** that scheme operators should not be allowed to borrow on behalf of the scheme more than 10% of the gross assets of the scheme unless the name of the scheme includes the word 'geared', or some other word approved by the ASC that indicates that it may have liabilities for borrowings, and the maximum permitted level of borrowing of the scheme is disclosed in any prospectus issued by the scheme operator. Schemes not so named should not be permitted to borrow an amount equal to more than 10% of the gross

19. T Valentine *Submission* 5 November 1992; Property Resources *Submission* 20 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; ASCPA & ICAA *Submission* 15 February 1993; Australian Film Commission *Submission* 7 January 1993.
20. Proposal 9.2.
21. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; MLC Investments Limited *Submission* 18 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
22. Mercantile Mutual Holdings Limited *Submission* 16 December 1992; Attorney-General's Department *Submission* 21 December 1992; T Valentine *Submission* 5 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992.
23. Property Resources *Submission* 20 November 1992.

assets of the scheme. Borrowing should be defined broadly to include not only loans and credit arrangements but guarantees, indemnities and other forms of contingent liability.

Valuation practices

The role of valuation

6.11 The value of the assets of a collective investment scheme is of vital importance to an investor. It determines the value of his or her investment in the scheme. Changes in the value of a scheme's assets change the value of each investor's investment. They also change the value at which investors in the scheme can redeem their investments. The methods used to ascertain these values are, therefore, particularly important. In collective investment schemes where all or most of the assets are traded in a market like the stock exchange or the commercial bank bill market, the value of the assets of the scheme is assumed to be the sum of the values quoted in those markets. The exit value of an investor's interest in the scheme is determined by deducting the scheme's exit charges from the value of the investor's share of the total investment pool. Schemes in which none or very few of the assets are traded in a market, on the other hand, will need to obtain an estimate of the market value of the scheme's assets before an appropriate redemption price can be calculated. The rapid collapse in the estimated value of the assets held by unlisted property trusts in 1991 and 1992 suggests that there may be some weaknesses in the methods used to estimate the value of the assets of those kinds of schemes.

Unlisted property trusts and valuation

6.12 The methods used to value the assets of unlisted property trusts were reviewed by the ASC following the freeze on redemptions from those trusts announced by the federal Government in July 1991. The ASC acknowledged in its policy statement on property trusts that

> the proper valuation of trust assets is crucial to the equitable treatment of unit holders given that valuations determine unit value in relation to new unit issues and buy-back and redemption of units.[24]

The ASC increased the frequency of required valuations from at least once every three years to once every year. It imposed a requirement on the trustee of each scheme to commission a new valuation of the assets of the scheme if the trustee or the manager is of the opinion that it is in the best interests of unitholders to do so. The ASC also required valuations of properties in a portfolio to be staggered to keep portfolio valuations more current and required that the instructions to the valuer be disclosed. The trustee is now required to instruct the valuer as to the method to be used to value the scheme's assets.[25] These requirements are in addition to the previously existing regulations which imposed requirements on trustees

24. ASC Policy Statement 16 para 16.
25. ibid.

- as to the appointment of an independent valuer with adequate experience[26]
- relating to the method of valuation[27]
- not to use the same valuer for more than two consecutive valuations.[28]

The Review's concerns

6.13 The changes to unlisted property trust valuation procedures introduced by the ASC addressed many of the concerns expressed at the time by industry commentators. However, some valuation practices adopted in recent times by unlisted property trusts and other collective investment schemes investing in assets that are not traded in a well developed market do not allow an accurate value for the assets of a scheme to be determined. In particular, the 'on-completion' basis for valuing the assets of collective investment schemes involving the construction of commercial buildings or other infrastructure projects is inappropriate for calculating the value of the scheme's assets, unless the investors in the scheme are not entitled to redeem their investments until completion. DP 53 sought comment on these concerns and suggestions to improve the accuracy of the values ascribed to the assets of schemes where a market price for the assets has to be estimated.[29]

Comments in submissions

6.14 Several submissions suggested that a solution to the problem lay in the adoption of standard industry wide valuation principles.[30] One submission, while supporting the use of independent valuers, was less hopeful that these principles would eliminate valuation problems.

> There seems to be no solution to the valuation problem. Valuations not based on market prices have been found to be inaccurate. Nevertheless, some independent valuation is required to prevent managers from inflating the values of their investments.[31]

Not surprisingly, real property was seen to be the most problematic asset to value, reflecting the concern with property trust valuations existing at the time this review commenced. One submission made quite detailed suggestions as to how to deal with the issue of real property valuations. The submission recommended

- the valuation of properties which are 'core' assets on the basis of their future earnings potential
- discounted cash flow to be used to value real property
- discount rates used in valuations to be disclosed
- a standard model to be used by valuers to generate discounted cash flow estimates

26. Corporations Regulations reg 7.12.15(5)(b), (c).
27. Corporations Regulations reg 7.12.15(5)(d), (e).
28. Corporations Regulations reg 7.12.15(5)(f).
29. Issue 9A.
30. Macquarie Investment Management Limited *Submission* 24 November 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; Hall Chadwick *Submission* 21 December 1992.
31. T Valentine *Submission* 5 November 1992.

- 'non core' real property which is to be disposed of in the next twelve months should be valued by applying a discount or a premium to the discounted cash flow valuation.[32]

Recommendation

6.15 The Review considers that the existing rules relating to valuations should continue, but as requirements imposed by the Corporations Law, not as covenants. In addition, it **recommends** that, as a minimum, all the relevant assumptions and discount rates used in valuations of scheme property and the other instructions given to valuers should be disclosed to investors in collective investment schemes in the annual report. The Review does not consider it appropriate to make a recommendation that prescribes a particular approach to valuation such as discounted cash flows. It **recommends**, however, that the methods, for example, discounted cash flow, which valuers should be allowed to use should be the subject of a further review by the ASC and industry representatives.

Valuation and secondary markets — no recommendation

6.16 DP 53 asked whether, if a secondary market was established for the units in collective investment schemes, the assets of a scheme should have to be revalued if the market price of units in the scheme moved by more than a prescribed percentage in any fixed period.[33] Some submissions supported the proposition that assets of collective investment schemes should be revalued in such circumstances.[34] Other submissions opposed such a requirement.[35] The Review accepts that the market price of interests in a collective investment scheme, the underlying assets of which have estimated values, may fluctuate above and below the actual value of the assets of the scheme. This may reflect market sentiment as well as factors that had not been taken into account in determining the estimated value. Accordingly, the Review makes no recommendation relating to mandatory valuations of assets of collective investment schemes listed on a secondary market.

External auditors

Appropriate role of external auditors

6.17 The Review envisages that the external auditor of a collective investment scheme, appointed by the operator, will play an important role in ensuring compliance with the law and the constitution of each scheme. Auditors of banks play a key role in checking adherence to prudential standards determined by the Reserve Bank of Australia. A similar role should be conferred on external auditors of collective investment schemes. The external auditor will often be well placed to

32. Lend Lease Property Funds Management Limited *Submission* 18 December 1992.
33. Issue 9B.
34. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; TCA *Submission* 17 December 1992.
35. T Valentine *Submission* 5 November 1992; Australian Institute of Valuers and Land Economists (Inc) *Submission* 8 December 1992; Mercantile Mutual Holdings Limited *Submission* 16 December 1992.

check adherence to compliance measures and to detect possible breaches. The accounting professional bodies agree.[36] The Review **recommends** that scheme operators should be required to provide the ASC with an annual certificate prepared by the external auditor stating that, in the auditor's opinion, the operator is giving effect to the compliance measures imposed by the Commission[37] as a condition of the operator's licence.[38] A copy of that certificate should be included in the annual report. The accounting professional bodies support these recommendations.[39] The auditor would not be under a duty to assess these compliance measures against 'best practice' principles.

External auditors to report

6.18 *The reporting role of external auditors.* Company auditors must draw breaches of the Corporations Law to the attention of the ASC.[40] They are given protection from civil liability when doing so.[41] Further, company auditors may only resign with the consent of the ASC.[42] The auditor of a prescribed interest scheme must report periodically to the manager whether the accounting and other records of the scheme comply with the relevant provisions of the Corporations Law.[43] DP 53 proposed that similar provisions should apply to external auditors of collective investment schemes, namely, that they should be obliged to report to the regulator

- any breach or suspected breach of the obligations imposed on the operators of collective investment schemes, or of any statutory or regulatory requirements
- a breach of the scheme constitution that comes to their notice in the course of dealing with or auditing a collective investment scheme.[44]

It also proposed that external auditors should receive appropriate protection for the contents of these reports or any other communications, formal or otherwise, they may have with the regulator. Submissions supported the Review's proposals.[45]

36. ICAA *Submission* 30 March 1993. It takes the view that auditors are ideally placed to form an opinion on compliance issues. The Review notes the work of the AASB in developing more rigorous and uniform accounting standards, and the impact of quality assurance programs being implemented by the professional accounting bodies. These developments would also impact on the auditing of collective investment schemes.
37. And agreed to by the directors of the operator.
38. An auditor would be liable only for losses resulting from negligently providing such a certificate.
39. ICAA *Submission* 30 March 1993.
40. Corporations Law s 332(9), (10).
41. Corporations Law s 1289.
42. Corporations Law s 329 (6). This is designed to protect auditors from manipulation by directors and to protect shareholders where an auditor wishes to resign rather than conclude a difficult audit. The ASC has issued a policy statement covering the circumstances that will influence it in granting consent: ASC Policy Statement 26.
43. This follows from Corporations Regulations reg 7.12.15 (6)(c).
44. Proposal 11.8.
45. eg TCA *Submission* 17 December 1992; Hall Chadwick *Submission* 21 December 1992.

6.19 ***Recommendation.*** The Review considers that effective ASC surveillance and enforcement will be enhanced by external auditors immediately notifying the Commission of possible malpractice. The Lavarch Report recommended that company auditors should be obliged to report to the ASC where they have 'reasonable grounds to suspect' any breach of the Corporations Law.[46] The Review **recommends** that external auditors of collective investment schemes should be subject to an obligation to report to the ASC where they have any reasonable grounds to suspect a breach of the law or the scheme constitution. An external auditor who communicates with or makes any report to the ASC, whether obligatory or otherwise, should have qualified privilege similar to that provided under Corporations Law s 1289. The Review also **recommends** that collective investment scheme auditors should only be able to resign or be removed in accordance with the procedure under the Corporations Law s 329.

6.20 ***Notifying the scheme operator.*** DP 53 asked whether an external auditor should be required to draw a possible irregularity to the attention of the scheme operator prior to, or at the same time as, notifying the regulator. It proposed that this should not be compulsory as it may impede the regulator's ability to respond quickly. There was some debate in the submissions on this matter.[47] The Review has concluded that, consistently with the principles governing company auditors, an external auditor of a collective investment scheme should not be required to provide any report to the scheme operator. This may be left to the discretion of the auditor.

46. House of Representatives Standing Committee on Legal and Constitutional Affairs *Corporate Practices and the Rights of Shareholders* November 1991, recommendation 18. This recommendation, which was supported by the accountancy bodies, would require an amendment to the Corporations Law s 332(10).
47. Macquarie Investment Management Limited *Submission* 24 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; ASCPA & ICAA *Submission* 15 February 1993.

7. Withdrawing from a collective investment scheme

Introduction

7.1 The apparent ease with which investors can leave collective investment schemes played a large part in their increasing popularity during the last decade. In some cases, however, investors' expectations were not met. In 1991 some investors in unlisted property trusts experienced difficulties when trying to redeem their investments. Eventually all redemptions in these trusts were suspended. This chapter examines how investors leave collective investment schemes and considers whether modifications to exit mechanisms are necessary to improve the efficiency and enhance the stability of collective investment schemes.

Exit mechanisms for collective investment schemes

7.2 There are four ways an investor may be able to withdraw his or her investment from a collective investment scheme:

- redeeming his or her interests from the scheme
- requiring the scheme operator to buy his or her interests in the scheme (buy back)[1]
- selling his or her interests on a recognised exchange or by private arrangement
- terminating the scheme and liquidating its assets.

Not all options are available to investors in all schemes. The mechanisms that have attracted the most attention in recent times are redemption and buy back. Redemption involves the investor being paid out of scheme funds, if necessary by liquidating some of the scheme assets. Buy back involves the manager of the scheme paying the investor from its own funds. Under the Corporations Law managers, unless they have been granted an exemption by the ASC, are obliged to buy from unitholders their interest in the scheme upon request.[2] Where the manager has been required to meet a buy back request, it may, and often does, redeem from the scheme the units it purchased from investors.[3] Investors in some schemes are able to dispose of their interests by selling to another person. Most property trusts, for example, are now listed on the ASX.[4] Listing enables schemes to avoid the liquidity problems associated with redemption and buy back mechanisms.[5] However, ASX listing is not an option for schemes that are not able

1. The term 'buy back' will be used in this chapter to describe all situations where the scheme operator purchases from investors some or all of their interests in a scheme, not just the current mandatory requirement on scheme managers to purchase interests offered to them by investors.
2. Corporations Law s 1069(1)(c).
3. The ability to do this depends on the terms of the trust deed. Most deeds provide for managers to redeem interests they purchase from investors.
4. In 1992, 80% of property trusts were listed.
5. These problems are discussed later in this chapter.

to meet the listing requirements. Terminating a scheme is an option available to investors in all schemes but it would only be used in extraordinary circumstances to facilitate the exit of all investors from the scheme.

Exit mechanisms and investor confidence

7.3 Investor confidence in collective investment schemes is likely to fall, and individual investors may suffer, if investors are unable to withdraw their funds in accordance with their expectations. However, inappropriate or unworkable exit rules may create false or unrealistic expectations in investors as to their ability to liquidate their investments. This occurred with unlisted property trusts, where investors were led to expect that they had ready access to their funds regardless of the state of the property market. The fault lay largely in the nature of the buy back obligation imposed under the Companies Code. The rules governing buy backs and redemptions must be appropriate for the type of scheme invested in. The present rules are not.

Exit mechanisms and commercial stability

7.4 The departure of investors from a collective investment scheme invested only in liquid assets rarely causes commercial instability. The scheme is able to pay out investors either directly (redemptions) or indirectly (buy backs by the scheme manager with a subsequent redemption of acquired interests) because its assets are liquid. The departure of investors from wholly or partly illiquid collective investment schemes, on the other hand, can lead to instability. This is because the scheme operator and the scheme itself may not have enough liquid funds readily available to pay out these persons. If more investors are entitled to leave the scheme than can be paid out from available liquid assets, the operator will need to sell assets of the scheme quickly. This can cause disruption in financial markets.

The compulsory buy back problem

Managers of illiquid schemes cannot be 'banker' to the scheme

7.5 The buy back obligation imposed on managers of prescribed interest schemes may enable investors to withdraw funds from illiquid schemes without the forced sale of scheme assets provided the manager has adequate funds of its own and it does not then seek to have the recently purchased interests redeemed from the scheme. If the manager does seek immediate redemption, as many scheme constitutions allow, the scheme will be in no better position as regards having to sell its assets than if it had been forced to meet a similar redemption request by the investor. The new property trust rules require managers and trustees to maintain the liquidity of the trust at at least 15% of the trust's assets value.[6] These require-

6. Corporation Regulations reg 7.12.15A. The liquidity of the trust is defined to include the liquidity of the trust plus an amount calculated with reference to the management company's liquidity, its assets and the net tangible assets of the trust.

ments are designed to assist scheme managers to meet buy back requests. The fact remains, however, that managers of illiquid schemes simply cannot act as banker to the scheme's investors.

Current buy back exemptions

7.6 For some time the ASC has recognised that a buy back obligation is inappropriate for some types of schemes and in some circumstances. It has issued exemptions from the buy back obligation including

- for agricultural and other tax based schemes
- for film investment schemes
- for certain fixed term real estate trusts and syndicates
- for listed trusts
- for interests issued in consideration for property sold into the trust
- while the office of manager is vacant and the trustee is temporarily acting as manager
- where the amount requested is less than a specified (relatively small) amount
- for trustee company common funds.

Fixing the buy back problem

Is suspending the buy back obligation a solution?

7.7 The problems caused by a buy back obligation could be alleviated by allowing operators to suspend the obligation whenever they are unable to meet it. This would effectively abolish the buy back obligation. Operators would have the benefit of seeming to guarantee customers a repurchase option without being required to ensure that the offer could be honoured in all cases. This would be misleading and would undermine investor confidence in the collective investments industry. To pre-empt possible loss, investors may seek to withdraw funds from schemes that are not in any difficulty, causing a run on those schemes. This potential for instability is contrary to the Review's policy objectives.

Proposal and submissions

7.8 The buy back obligation has been criticised by both trustees and managers.[7] DP 53 suggested that the only sustainable option is to prohibit operators of collective investment schemes from offering a buy back obligation. It proposed that the present buy back obligation should be abolished and that the law should

7. eg Perpetual Trustees Australia Limited *Submission* 15 November 1991; St George Funds Manager *Submission* 18 December 1992; MLC Investments Ltd *Submission* 17 December 1992.

prohibit scheme operators from offering investors a compulsory buy back facility.[8] The majority of submissions that commented on this issue supported the proposal.[9] However, an opposing view was also put to the Review.

> If a management company has sufficient capital to offer a buy back facility and is willing to do so then the provision of such a facility should not be banned. If investors believe that a buy back facility is an important feature of their scheme then they should be given the opportunity to invest in such a scheme.[10]

Recommendations

7.9 The Review remains of the view that the law should not impose a buy back obligation. The existing statutory obligation on scheme managers to buy back interests, combined with their right to redeem from scheme assets interests they have bought from investors, is fundamentally misguided for illiquid schemes. The effect is to impose on scheme managers an obligation they may not be able to fulfil. Its failure with unlisted property trusts caused great damage to commercial stability and investor confidence in the collective investments industry. Requiring higher levels of liquidity in illiquid schemes to enable schemes to redeem interests purchased from investors by managers is no solution. It simply forces those schemes to hold a greater proportion of their assets in cash or immediately convertible assets, with the possible loss of other investment opportunities. It also assumes that a high enough liquidity requirement can be found that will satisfy all redemption requests.The Review **recommends** that the existing statutory buy back obligation should be repealed. The voluntary undertaking of an obligation to make a buy back offer is dealt with at paragraph 7.12.

Operators holding interests in their own collective investment schemes

Issue raised for comment

7.10 DP 53 called for comment on whether scheme operators should be prohibited from, or restricted in, holding interests in their own collective investment schemes and whether any such prohibition or restriction should extend to related parties.[11] While there was some support for a prohibition on operators holding interests in their own collective investment schemes,[12] a majority of

8. Proposal 8.1.
9. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; ISC *Submission* 12 November 1992; Australian Film Commission *Submission* 7 January 1993; MLC Investments Limited *Submission* 17 December 1992; TCA *Submission* 17 December 1992; T Valentine *Submission* 5 November 1992; M Starr *Submission* 12 November 1992.
10. Minter Ellison Morris Fletcher *Submission* 24 November 1992. See also Macquarie Investment Management Limited *Submission* 24 November 1992. Other submissions that supported permitting a voluntary buy back obligation included ASCPA & ICAA *Submission* 15 February 1993; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; Treasury *Submission* 24 December 1992.
11. Issue 8A.
12. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Hall Chadwick *Submission* 21 December 1992; FPAA *Submission* 7 December 1992.

submissions opposed the idea.[13] They argued that it is sometimes desirable for an operator to hold interests in its own scheme to provide initial seed capital and so overcome some of the difficulties involved in commencing operation.[14] It was also noted in submissions that investment by an operator can be likened to 'hurt' money: if the operator does not act in the interests of scheme investors, it is directly penalised through its ownership of scheme interests.[15] Another concern expressed was that the proposal, if implemented, would aggravate liquidity problems associated with collective investment schemes.[16] Its ability to hold interests in its scheme enables the operator to inject liquidity into the scheme by buying interests rather than by selling scheme assets.

Recommendations

7.11 ***Buying new interests.*** The Review notes the support expressed in submissions for the right of operators to own interests in the schemes they promote. It agrees with the reasons advanced in favour of permitting such holdings. The Review **recommends** that a scheme operator should be able to purchase new interests in a scheme on the same basis as other investors. Restrictions on its right to vote in respect of those interests[17] and the fiduciary obligations it will owe to investors will guard against a scheme operator using its interests to the disadvantage of other investors.

7.12 ***Buying existing interests from investors.*** The Review considers that the purchase by scheme operators of existing interests in a scheme should not be prohibited. However, selective purchasing by an operator should not be permitted. If an operator wishes to purchase existing interests in its scheme, rather than buy new interests, it should only be allowed to do so on a basis that is fair to all investors. A scheme operator may choose to make ad hoc offers, or no offers, to buy interests from other investors. Alternatively, the scheme constitution may require the operator to make a certain number of offers to investors each year or to offer continuously to purchase interests from investors. Any offer a scheme operator makes to investors to purchase interests should be subject to rules prescribed in the Corporations Law. These rules should ensure that investors who accept a buy back offer by a scheme operator are treated equally. A buy back offer should be made in the following way:

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13. Macquarie Investment Management Limited *Submission* 24 November 1992; National Mutual *Submission* 3 December 1992; Australian Film Commission *Submission* 7 January 1993; BT *Submission* 15 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992; M Starr *Submission* 12 November 1992; Mercantile Mutual Holdings Limited *Submission* 16 December 1992; ASCPA & ICAA *Submission* 15 February 1993; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992; ISC *Submission* 12 November 1992.
14. M Starr *Submission* 12 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; National Mutual *Submission* 3 December 1992; IFA *Submission* 1 December 1992.
15. National Mutual *Submission* 3 December 1992.
16. Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992; National Mutual *Submission* 3 December 1992.
17. See para 11.26.

- The offer should be at a price calculated in accordance with the scheme constitution.

- All investors should be given written notice of the offer within three days of the offer date.[18]

- The offer notice should disclose the amount of money that the operator intends to spend on interests in this offer. It should also stipulate a closing date for acceptances, not less than 28 days from the offer date.

- The scheme operator should lodge a copy of the buy back offer with the ASC before, or immediately upon the commencement of, the offer period. The directors of the operator should also lodge a signed statement, dated not more 21 days prior to the offer date, certifying that the operator has funds available to honour the offer.

- The notice should explain the buy back rules and procedures and state that full details of the offer (unless included in the notice) are set out on the buy back application form, or a document attached to that form. It should also state where, or how, the application form may be obtained (if not included in the notice) and that the buy back offer may be accepted only by completion of an application form. The application form or a document attached to it should also explain the buy back rules and procedures.

- Buy back offer periods should not overlap.

- If more interests are offered by investors than can be purchased by the scheme operator with the funds specified in the buy back notice, interests should be purchased from investors on a pro rata basis.

- If interests are purchased on a pro rata basis, the scheme operator should, within five business days, lodge a notice to that effect with the ASC.

Scheme operators should be prohibited from entering arrangements to avoid these provisions, either directly or indirectly. Interests acquired under a buy back offer should only be redeemable in accordance with the statutory redemption procedure.[19]

7.13 ***Disclosure of buy back arrangements.*** The Review has considered whether there should be specific requirements for scheme operators to disclose in prospectuses whether they intend to make any offers to buy back investors' interests. Whether the scheme operator is required under the scheme constitution to make buy back offers or otherwise intends to make buy back offers is material to assessing the merits of participating in a scheme. Consequently, disclosure of this information would be required under the existing law.[20] However, the Review **recommends** that the annual and half yearly reports of a collective investment

18. cf Corporations Law s 638(2).
19. Para 7.21.
20. Corporations Regulations reg 7.12.12.

scheme should provide information about recent buy back offers. They should set out the number of interests acquired by the operator and details of any use of the pro rata procedure in the period of the report. Full disclosure of this information will help to ensure that investors have realistic expectations about their ability to withdraw from a scheme by selling their interests to the operator.

Redemption

The problem

7.14 Redemption of investments requires assets of the scheme equal to the investor's share of the total scheme assets to be liquidated to pay the investor seeking to withdraw from the scheme. If the assets are easily divisible and saleable, for example listed equities or interest bearing paper, redemption is readily effected. This is not the case if the assets of the scheme are illiquid in whole or part. A property trust that owns one or two commercial properties, for example, will not be able to meet redemption requests unless the scheme's assets include sufficient cash or other liquid assets in addition to the real property. Without adequate liquid assets in the scheme the operator will have to sell an asset of much greater value than would be necessary to meet the redemption request. Even if a scheme that is invested mainly in illiquid assets holds some liquid assets, as soon as more redemption requests are received than can be met from those liquid assets, the scheme will have difficulty meeting the requests.

Redemption at call in fully liquid schemes

7.15 ***Proposal.*** Many submissions on IP 10 recognised that redemption from scheme assets is only viable if enough assets are liquid.

> Our view is that schemes marketed to the retail sector should be of a liquid nature, and therefore the underlying assets should also be liquid. Once this view is accepted, it follows that since the assets are liquid no buy back requirement is necessary as the nature of the assets themselves will satisfy redemption.[21]

The Review accepted this line of argument and proposed in DP 53 that only collective investment schemes in which a prescribed percentage (for example, 80%) of the assets are able to be liquidated on a recognised exchange should be allowed to offer an at call (that is, up to seven days) redemption facility.[22]

7.16 ***Submissions.*** The vast majority of submissions supported the principle underlying the proposed redemption restriction, namely, that investments should only be redeemable at call if the assets themselves are liquid.[23] There was some

21. MLC Investments Limited *Submission* 22 November 1991.
22. Proposal 8.2.
23. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992. Those opposed to the proposal included BT *Submission* 15 December 1992; Mercantile Mutual Holdings Limited *Submission* 16 December 1992; ASCPA & ICAA *Submission* 15 February 1993.

concern, however, that the requirement for assets to be able to be liquidated on a 'recognised exchange' was too narrow. It was suggested that this formulation did not encompass certain highly liquid assets such as government bonds or bank bills. It was also argued that this requirement would have to be amended for interfund investment. If a scheme invests in interests of another scheme, the investment may not meet DP 53's proposed criteria for liquidity, even though the assets of the other scheme may be liquid.

7.17 ***Recommendation.*** Investors in fully liquid schemes, such as 'cash management trusts', should not be denied the opportunity to redeem their investments at call. 'Feeder funds', which only hold interests in other schemes, may be equally capable of offering a redemption at call facility where the assets of the schemes in which they are invested are fully liquid. The Review therefore considers that schemes that invest in specifically transferable securities like bank bills and shares, including 'feeder funds' should be able to offer at call redemptions. However, the Review **recommends** that any redemption offer made must be made to all investors on the same terms. There is no need for any other legislative restrictions on redemptions by these schemes. Details of redemption offers would have to be disclosed in any prospectus.

Redemption in wholly or partly illiquid schemes

7.18 ***Proposal.*** The fundamental problem in providing a redemption facility for less than fully liquid schemes (illiquid schemes) is that it is not always possible to liquidate part of a scheme's assets to meet redemption requests, certainly not without disadvantaging continuing investors or even possibly jeopardising the future of the scheme. While the liquidity requirement imposed on property trusts may improve the ability of investors to redeem their interests, it will not guarantee it. DP 53 proposed that, instead of requiring longer redemption periods for illiquid schemes, investments in these schemes should be for fixed periods.[24] The Review considered that imposing a fixed term on investors would enable scheme operators to manage their cash flow better because they would know in advance the maximum number of investors who could seek to redeem their interests on any particular day. Under the current system, the operator of a scheme does not know this. All investors could ask simultaneously for their interests to be redeemed.

7.19 ***Submissions.*** The Review received considerable support for this proposal.[25] Some submissions, however, while supporting the proposal in principle, suggested that investors should be required to notify the operator before the fixed period expired if they intended to withdraw their investment on the date it fell due.[26]

> We would suggest that in addition to what has been proposed, that a standard redemption notice period be required. As the shortest fixed term period the Review is envisaging is six months, unless [scheme operators] have a way of anticipating the

24. Proposal 8.3.
25. eg Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; National Mutual *Submission* 3 December 1992; TCA *Submission* 17 December 1992; FPAA *Submission* 7 December 1992.
26. Macquarie Investment Management Limited *Submission* 24 November 1992; St George Funds Manager Limited *Submission* 18 December 1992.

> redemption outflow requirement on the actual redemption date, they are in no better position than they were at the beginning of the six month period to ensure that sufficient assets have been liquidated to meet those redemption requests.[27]

Some submissions suggested as an alternative to fixed term investments that schemes should have appropriately long redemption notice periods.

7.20 ***The particular problem of illiquid schemes.*** Investors in illiquid schemes may believe that they are acquiring a readily convertible investment. This belief is false. There can be no guarantee that their interests will always be redeemable, for value, from scheme assets. Any redemption regime must balance the interests of applicants for redemption, both amongst themselves and against the interests of remaining investors. The current regime, by not matching redemption requests to the cash available in the scheme, fails to do this. To require a scheme to sell non-liquid assets, or borrow against non-liquid assets, to honour redemption requests in excess of the available liquidity may adversely affect the scheme's asset base and the interests of its continuing investors. The DP 53 proposal to impose fixed investment terms would not solve this problem. It assumes that assets can be liquidated in time to meet anticipated redemption requests. Market forces may mean this is not possible. Also, investors may prefer to submit a notice of redemption at a time of their choosing rather than on a fixed date. A better approach is to match redemptions directly to available liquidity through a pro rata mechanism that ensures equality of treatment where redemption requests exceed available liquidity.

7.21 ***Recommendation.*** The Review **recommends** that the operator of a scheme that is not entirely liquid should not be allowed to make redemption offers other than in accordance with rules prescribed in the Corporations Law. Many of the rules the Review recommends should be prescribed are the same as those it recommends for the buy back of existing interests by scheme operators.[28] They are designed to ensure that investors are treated equally. Redemption offers should be made as follows.

- Any offer should be for a minimum of 28 days.[29]
- A scheme operator should lodge a notice of a redemption offer with the ASC.[30]
- Offer periods should not overlap.

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27. St George Funds Manager Limited *Submission* 18 December 1992.
28. See para 7.12.
29. Without a significant offer period, the pro rata procedures could be circumvented. A scheme operator could, for instance, run a redemption offer for only a nominal period, thereby permitting itself and any other applicants to take all or a disproportionate amount of limited liquid funds. The 28 day period would permit scheme operators to make calendar month offers. A high liquidity scheme could run successive monthly offer periods. It would suffer no commercial detriment vis-a-vis fully liquid schemes, other than a delayed settlement.
30. This notice would be an independent verification that an offer has been made.

- The offer should be open to all eligible investors on the same terms.[31]
- Investors who have requested redemption of their interests in the period since the last redemption offer should be sent details of the redemption offer and an application form.
- A scheme operator should not have to provide a written offer to other investors but should provide a copy of the offer and an application form, at no cost, to investors upon their request.[32]
- Redemption requests should have to be made by completing an application form which should explain the redemption rules, in particular, that if more redemption requests are made than can be funded from the liquid assets of the scheme at the end of the offer period the requests will be met on a pro rata basis.
- The scheme operator should not stipulate the funds available for each redemption offer. Instead, the scheme operator should meet redemption requests from the liquid assets of the scheme, being cash on hand and other assets immediately convertible into cash, on the day following the close of the offer period.[33]
- Redemption requests should be paid out at a price calculated in accordance with the scheme's constitution.
- If the liquid assets of the scheme are insufficient to meet all redemption requests lodged in the offer period, the requests should be met on a pro rata basis and the applicants for redemption advised accordingly.
- An investor who wants to redeem any interests that could not be redeemed in a particular redemption period should have to complete another redemption application form during a later redemption period. Their initial request should not be carried forward automatically.[34]
- Each time a scheme is obliged to meet redemption requests on a pro rata basis it should, within five business days of the end of the redemption period, notify the ASC of this fact.

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31. The scheme constitution may require that interests be issued for a minimum period before they are eligible for redemption.
32. To require written offers to all investors for each redemption period would involve high administrative costs. Also the initiative to request redemption would come from investors.
33. This differs from buy backs where the available funds of the scheme operator must be identified in the buy back offer. The later date for redemption better ensures that redemptions are met only from liquid scheme assets then available.
34. Investors who have requested redemption of their remaining interests will, under the Review's earlier recommendation in this paragraph, automatically receive details of the next redemption offer and an application form.

As with information about buy back offers, the Review considers that information about the procedures by which investors may apply for redemption of their interests, whether there is any obligation on the operator to make redemption offers and, if so, the nature of the obligation,[35] would be material to assessing the merits of participating in a scheme. Disclosure of this information would, therefore, be required under the existing law.[36] The Review **recommends**, however, that annual and half yearly reports should include information about recent redemption offers and whether the pro rata mechanism was used. All application forms for new interests should also explain the redemption rules or draw attention to the redemption section of the prospectus. This will ensure that investors are adequately informed of the redemption process.

7.22 *No statutory obligation to redeem.* The Review does not support any statutory obligation on scheme operators to offer redemptions. To do so may lead investors to believe that they have some right of redemption for value, regardless of the nature of the assets held by the scheme. Any failure to honour redemption requests under a compulsory redemption system may give the false impression that a scheme is failing and cause an unnecessary acceleration of redemption requests and the loss of new investments. The scheme operator is best placed to determine when to make redemption offers. The Review has considered whether the lack of a statutory redemption obligation may result in scheme operators locking in investors by declining to make redemption offers. There are various market forces which will greatly reduce this possibility. A scheme constitution could give some certainty to investors by requiring the operator to make redemption offers at stipulated times or with a stipulated frequency.[37] Persistent failure to offer redemptions would discourage new investors. In addition, investors may have recourse against the scheme operator, including calling a meeting of investors to replace the operator, or seeking an oppression or other judicial remedy.[38] The Review is satisfied that there are effective disincentives against scheme operators attempting to lock investors into schemes indefinitely.

A secondary market for interests in collective investment schemes

7.23 Restricting the ability to withdraw funds from illiquid schemes may reduce their attractiveness. One means of providing investors with ready access to their investment, while recognising the limitations facing an operator attempting to provide access, would be to establish a secondary market for all interests in illiquid collective investment schemes. IP 10 asked whether a secondary market for such

35. These obligations would refer to the frequency of making offers. A scheme constitution may not provide for a redemption process which differs from the statutory procedures recommended in this paragraph.
36. Corporations Regulations reg 7.12.12.
37. A scheme constitution could not provide for a redemption process that departed from the statutory procedures for making offers and pro rata distributions as described in para 7.21. A provision in a scheme constitution requiring the operator to make periodic redemption offers would not provide investors with a guarantee that they would be able to redeem their interests.
38. See further ch 11.

schemes should be established.[39] The question received both positive and negative responses.[40] DP 53 called for comment on whether the introduction of a secondary market for trading investments in all illiquid collective investment schemes should be considered.[41] Again there was a mixed response. Some respondents supported the creation of a secondary market.[42] Others opposed it, principally on the ground that secondary markets can restrict capital raising as investors go to the secondary market, rather than the primary market, to invest.[43] Other submissions commented on the possible difficulty of sustaining a viable market in interests in collective investment schemes.

> [T]he existence of a marketplace for the trading of securities of collective investment schemes will not, of itself, mean that the market will be attractive to investors. A market is attractive to investors if it operates efficiently, at low cost and is liquid . . . Unless a market has . . . liquidity present to a significant degree, it is unlikely that the market would be successful (ie attractive to investors both domestic and foreign).[44]

Whether a secondary market is established for interests in all illiquid collective investment schemes is not a question for government. It is a question for the market. In principle, such a secondary market would be a desirable development, as it would widen the range of exit mechanisms available to investors. The Review supports in principle the establishment of such a market for interests in all illiquid collective investment schemes but acknowledges the concerns expressed about the viability of such a market. It also acknowledges that because many larger illiquid schemes have already listed on the ASX there may not be enough schemes to provide depth to a secondary market for interests in collective investment schemes.

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39. Issue 48.
40. Those in favour included Perpetual Trustees Australia Limited *Submission* 15 November 1991; Australian Property Alliance *Submission* 11 October 1991. Those against included: MLC Investments Limited *Submission* 22 November 1991; Purvis, van Eyk & Company Limited *Submission* 12 November 1991.
41. Issue 8B. It was envisaged that such a market would operate in a similar fashion to the bank bill market, which allows holders of nominally fixed term investments to sell to a third party their right to be repaid on maturity of the bank bill.
42. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; TCA *Submission* 17 December 1992.
43. Macquarie Investment Management Limited *Submission* 24 November 1992.
44. ASX *Submission* 22 December 1992.

8. Terminating, winding up and voluntary administration of a scheme

Introduction

8.1 This chapter considers the termination and winding up of collective investment schemes. It also considers issues arising when collective investment schemes or their operators become insolvent. Because a collective investment scheme does not have a separate legal identity, a distinction needs to be drawn between the termination of a scheme and its subsequent winding up. Termination refers to the scheme ceasing to operate as a scheme — essentially, taking no more subscriptions or ceasing to carry on the business for which the scheme was set up. Winding up refers to the collection and liquidation of assets, the payment of debts of the scheme and the distribution of the surplus, if any, in accordance with the scheme's constitution.

Grounds for terminating a scheme

The present law

8.2 The trustee of a prescribed interest scheme must convene a meeting of interest holders to consider whether the scheme should be wound up if any of three events occur:

- if the management company is being wound up
- if the management company has, in the opinion of the trustee, ceased to carry on business
- if the management company has, in the opinion of the trustee, failed to comply with a provision of the deed to the prejudice of holders of interests in the scheme.[1]

Winding up requires both a resolution of investors and approval by the court. The Corporations Law does not make any other provision for the winding up or interim administration of an insolvent prescribed interest scheme. Trust deeds, however, often provide that the trust is to be terminated three months after the manager gives written notice to the trustee.

Should termination be necessary?

8.3 The rule against perpetuities (more correctly described as a rule against remoteness of vesting) limits the life of trusts.[2] A collective investment scheme that is a trust may infringe this rule where its constitution does not specify limits for the

1. Corporations Law s 1074.
2. The rule provides that an interest in property not vested at its creation, in order to be validly created, must vest, if it vests at all, not later than 21 years after the termination of a life or lives in being at the date of the creation of the interest: RP Meagher & WMC Gummow *Jacobs' Law of Trusts in Australia*, 5th ed, Butterworths, 1986, para 930.

vesting of property held under the trust. The Corporations Law already addresses this problem in relation to trusts for the benefit of employees of a corporation by excluding them from the application of the rule against perpetuities.[3] The CSLRC Report concluded that the rule against perpetuities should not apply to participatory investment schemes.[4] The Review agrees. It **recommends** that the exclusion of the rule against perpetuities in the Corporations Law should be extended to all collective investment schemes. Collective investment schemes will therefore be able to continue indefinitely, provided their constitutions so allow and they are not terminated.

Termination under the constitution

8.4 Not all collective investment schemes are intended to continue indefinitely. The constitution of a scheme may specify events or states of affairs whose occurrence will cause the termination of the scheme (for example, by specifying a particular termination date). However it is not in the interests of investors for a scheme operator to seek to entrench itself through a termination provision. The Review **recommends** that any provision in the constitution that would terminate the scheme if the scheme operator is removed should be ineffective.

Termination by investors

8.5 ***General procedure***. DP 53 proposed that investors should have the right to terminate a collective investment scheme where the scheme operator

- suspends redemptions from the scheme
- ceases to carry on business
- has its licence suspended or revoked in relation to the scheme.[5]

The Review now considers that the rights of investors to terminate a scheme should not be so limited. If a sufficient majority of investors wish to terminate a scheme, they should be able to do so. The Review **recommends** that investors should be able to terminate a collective investment scheme, for any reason, by the vote of the holders of more than 50% of the value of the interests in the scheme (other than interests held by the scheme operator or its associates).[6] The high threshold of 50% ensures that investors cannot have the scheme terminated without their involvement. Investors aggrieved by a termination resolution could challenge it for oppression or on the grounds that the resolution was not passed in accordance with the law.

8.6 ***Insolvent schemes***. The Review considers that there should be a lower threshold than 50% of all investors for terminating an insolvent scheme. It **recommends** that investors should be able to terminate an insolvent scheme by special resolution of three quarters of the investors by value (other than the scheme

3. s 1346.
4. CSLRC Report *Prescribed Interests* 1988 para 96.
5. Proposal 7.15.
6. The rules in relation to voting on a resolution, including those affecting interests held by the scheme operator or its associates, are discussed at para 11.26, 11.27.

operator and its associates) voting on the resolution. This method of terminating a scheme should only be available where the scheme operator has obtained a certificate from an external auditor stating that the scheme is insolvent.

Termination by the court

8.7 ***Just and equitable ground.*** Investors may apply to the court for relief on the ground of oppression. One of the remedies that the court can grant on such an application is to order that the scheme be terminated.[7] A court may also order that the scheme be terminated after considering a report by a temporary operator appointed by the court.[8] However, these limited circumstances may not give the court enough control over collective investment schemes. The Review **recommends** that the court should have the power to terminate a scheme whenever it is of the opinion that it would be just and equitable to do so. The following parties should be entitled to apply to the court for termination on this ground:

- the ASC
- the scheme operator or temporary scheme operator
- a director of the scheme operator
- an investor.

An individual director of a scheme operator might apply in response to actions of the majority of directors which he or she considers not to be in the interests of investors. An individual investor might apply for a termination order where he or she believes termination is necessary. Courts could control vexatious or unmeritorious applicants through appropriate cost orders.

8.8 ***Insolvency.*** The Corporations Law Pt 5.4 permits the court to order the winding up of an insolvent company.[9] An application for winding up may be made by the company, a creditor, a contributory, a director, a liquidator or provisional liquidator, the ASC or a prescribed agency.[10] There are significant differences between companies and collective investment schemes which will increase the incentive for scheme creditors to move against the scheme operator rather than wind up the scheme. While a company is a separate legal person, a scheme is not. Where schemes are constituted as trusts, the scheme operator will be personally liable for debts of the scheme, but will have a right of indemnity out of the scheme property. Creditors will therefore generally take action to recover their debts, including insolvency proceedings, directly against the scheme operator. The Review endorses as equally applicable to collective investment schemes constituted as trusts the recommendations made in the ALRC's report *General Insolvency Inquiry* (ALRC 45, 1988) concerning the right of indemnity of a trustee of a trading trust.

7. For the oppression remedy, see para 11.33.
8. For the appointment of temporary scheme operators see para 14.20.
9. s 459A. This is referred to as 'winding up in insolvency'. References to the insolvency provisions take into account the amendments introduced by the *Corporate Law Reform Act 1992* (Cth). Those amendments, which broadly implement the recommendations of the ALRC's report *General Insolvency Inquiry* (ALRC 45) come into force in June 1993.
10. Corporations Law s 459P(1).

- A provision in a trust deed excluding the trustee's right of indemnity against the trust property should be void against the liquidator. The effect of this recommendation is that the Corporations Law s 233 will not apply to collective investment schemes that are trusts. The interests of investors are protected as their personal liability for scheme debts is confined to any amount unpaid on their units.[11]

- The trustee's right of indemnity against the trust property and any right of indemnity against the beneficiaries should be a collective right exercisable by the liquidator on behalf of all trust creditors. The right should be subject to an order of the court. A court order may be necessary, for example, to protect the rights of secured creditors.[12]

- Assets recovered as a result of the exercise of the trustee's right of indemnity should be reserved for the payment of trust creditors.[13]

- Proceeds should be distributed, first, to pay costs associated with the exercise of the right of indemnity and the administration of property obtained as a result of the exercise of the right, and, secondly, to pay the administration costs of the winding up.[14]

- The right of indemnity should include not only the amount of the trust debts and liabilities but also the total costs associated with the winding up.[15]

The insolvency provisions of the Corporations Law, including the provisions for increasing the assets available to creditors by recovery of preferences, will apply in proceedings against the operator. If the collective investment scheme is a partnership, creditors will have joint and several rights against each of the partners unless it is a limited partnership. Creditors will therefore take action for recovery of debts against the partners. Insolvency proceedings against the partners will be governed by the *Bankruptcy Act 1966* (Cth) or the Corporations Law, depending whether the partners are individuals or companies. Creditors would therefore not usually be interested in taking action to wind up a collective investment scheme. Nevertheless, a procedure should be available for winding up a collective investment scheme in insolvency. The Review **recommends** that the court should have the power to terminate an insolvent scheme on application by a creditor, the scheme operator, a director of the scheme operator, a liquidator or provisional liquidator of

11. ALRC 45 para 251. The Review recommends at para 11.37 that the liability of investors in collective investment schemes that are trusts should be limited.
12. ALRC 45 para 261.
13. ALRC 45 para 265.
14. ibid.
15. ibid.

the scheme operator or the ASC.[16] The Review also **recommends** that an applicant should be required first to obtain leave of the court by establishing a prima facie case that the scheme is insolvent.[17]

Termination by the operator

8.9 If the purpose for which a scheme has been set up has been accomplished or is no longer capable of being achieved, there should be a simple procedure for terminating the scheme without a meeting of investors. However, the interests of investors should be protected. The Review **recommends** that the operator should be permitted to notify investors and the ASC where either of these circumstances applies and advise that the scheme will be terminated in 28 days unless the operator receives a requisition from investors or the ASC for a meeting of investors to consider a resolution that the scheme not be terminated but that the constitution of the scheme be amended appropriately.[18] Any meeting should have to be held within two months after the day the operator receives the requisition. In the intervening period, the scheme should continue. If neither the ASC nor investors require a meeting to be called, the scheme operator should be able to terminate the scheme at the end of the 28 day period. The Review recommends elsewhere in this report that scheme operators should be under a statutory duty to prefer the interests of investors in the scheme over their own interests where these are not identical.[19] This duty will guard against abuse of this termination power, for example, where a scheme operator otherwise might terminate a scheme merely because it is not providing it with sufficient fees or other returns.

Offence to continue a terminated scheme

8.10 The Review **recommends** that it should be an offence for the scheme operator to continue, including by taking new contributions, a scheme that has been terminated, without a court order.

Rules governing winding up

Procedures

8.11 The legal form of a collective investment scheme (for example, partnership or trust) and the terms and conditions of its constituting document will affect the rules governing its winding up. The Review **recommends** that some matters which are common to the winding up of collective investment schemes in which the

16. Scheme operators and their directors may want to terminate a scheme, given the liability of scheme operators for scheme debts. For what constitutes an insolvent scheme, see para 8.13.
17. cf Corporations Law s 459P(2), (3) where the company itself and a creditor (other than a contingent or prospective creditor) of the company may apply for winding up without prior leave. In collective investments, creditors have remedies directly against the scheme operator. Given this, to require applicants for winding up of a collective investment scheme to obtain prior leave would not be oppressive.
18. For the investors' power to requisition a meeting see para 11.23. For the ASC's power to requisition a meeting see para 14.26.
19. See para 10.8.

scheme operator holds the scheme property should be included in the Corporations Law. These matters, based on various corporate winding up and voluntary administration provisions, include

- who can be the liquidator of a scheme (for example, the person must be a registered liquidator and independent of the scheme operator and must not be insolvent)[20]
- the appointment of a liquidator to a scheme should have the effect of removing the scheme operator and the liquidator should have all the powers the scheme operator had[21]
- persons dealing with the scheme liquidator should be entitled to assume that the liquidator is acting within power[22]
- certain types of enforcement action against property of the scheme[23] and transfers of rights in the scheme[24] should be void after the scheme is terminated
- the liquidator should be entitled to require certain assistance in winding the scheme up (for example, the liquidator should have a right to books of the scheme,[25] the directors and secretary of the scheme operator should be required to give a statement of affairs of the scheme[26] and officers of the scheme operator should be required to give other information that the liquidator reasonably requires[27])
- the liquidator should be required to report possible offences to the ASC[28]
- the liquidator's remuneration should be fixed by the creditors of the scheme or by the court[29]
- the court should have power to remove a scheme liquidator[30] and appoint a new liquidator to fill a vacancy arising from the removal or otherwise[31]
- property of the scheme should be distributed first in payment of liabilities of the scheme and then to investors.[32]

20. cf Corporations Law s 448A, 448B, 448C, 448D (voluntary administration), 532 (winding up).
21. cf Corporations Law s 437C, 437D (voluntary administration), 474 (court winding up), 495(2) (members' voluntary winding up), 499(4) (creditors' voluntary winding up).
22. cf Corporations Law s 442F (voluntary administration), 505 (voluntary winding up).
23. Attachment, sequestration, distress or execution: cf Corporations Law s 440G (voluntary administration), 468(4) (court winding up), 500(1) (creditors' voluntary winding up), 570 (winding up generally).
24. cf Corporations Law s 468(1) (court winding up).
25. cf Corporations Law s 438B(1), 438C (voluntary administration), 530A(1), 530B (winding up).
26. cf Corporations Law s 438B(2) (voluntary administration), s 475(1) (court winding up).
27. cf Corporations Law 438B(3) (voluntary administration), s 475(2), (3) (court winding up), 530A(2) (windings up generally).
28. cf Corporations Law s 438D (voluntary administration), 533 (winding up).
29. cf Corporations Law s 449E (voluntary administration), 473(3)-(6) (court winding up), 495(1) (members' voluntary winding up), 499(3) (creditors' voluntary winding up).
30. cf Corporations Law s 449B (voluntary administration), 473(1) (court winding up), 503 (voluntary winding up).
31. cf Corporations Law s 449C(6), 449D (voluntary administration), 473(7) (court winding up), 495(3) (members' voluntary winding up), 502, 503 (creditors' voluntary winding up).
32. cf Corporations Law s 501 (voluntary winding up). Provisions for proofs of debt in the winding up of a collective investment scheme will be required. They can be based on the provisions in the Corporations Law and Regulations Pt 5.6. The Review's draft legislation does not include such provisions.

The Review **recommends** that, in addition, there should be a wide power for the court to give directions in relation to the winding up of a scheme. Directions given under this power would override the ordinary rules for winding up or any provision in the scheme's constitution.

Winding up expeditiously

8.12 There should be no unjustified delay in winding up the affairs of a collective investment scheme that has been terminated. The Review **recommends** that a registered liquidator should be appointed either by the court or the scheme operator[33] to a scheme that has been terminated to ensure that it is wound up expeditiously. The Review also **recommends** that the liquidator should be able to continue to carry on the business of the scheme if this is for the better winding up of the scheme.[34] This may be appropriate, for instance, to avoid assets being sold at a considerable discount because of the temporary condition of the market.

Voluntary administration of insolvent schemes

8.13 The voluntary administration procedure in the Corporations Law Pt 5.3A[35] permits the directors of an insolvent company to appoint an administrator to the company. The administrator, a professional insolvency practitioner, investigates the affairs of the company, formulates a proposal to deal with the insolvency and submits the proposal to creditors. The proposal may involve an arrangement with creditors, the winding up of the company or the ending of the administration. The Review considers that a similar procedure should be available for insolvent collective investment schemes. An alternative to this procedure would be the appointment of a judicial manager along the lines of the *Life Insurance Act 1945* (Cth).[36] The Review favours a procedure based on Corporations Law Part 5.3A. It **recommends** that the voluntary administration procedure in Pt 5.3A should be adapted to permit an administrator to be appointed to deal with the affairs of an insolvent scheme. A scheme would be taken to be insolvent if the operator of the scheme is unable to pay out of the property of the scheme all the debts incurred by the operator in respect of the scheme as and when they become due and payable.[37] The scheme operator should be able to appoint an administrator by resolution of its board of directors.[38] A temporary scheme operator should have the option of placing a scheme under administration if it considers that procedure to be the most

33. The court will appoint the liquidator if the scheme is terminated by order of the court. The scheme operator will appoint the liquidator in other cases.
34. cf Corporations Law s 1069(12) which permits continuation where the trustee and management company agree.
35. In force in June 1993: see footnote 9.
36. Pt III Div 8.
37. cf Corporations Law s 95A. The Review notes possible inadequacies in this exclusive definition of insolvency. The definition focuses on whether a company can pay its debts at a particular time and does not allow for the overall financial state of the company to be taken into account in determining insolvency. The Review's draft legislation reflects the current s 95A. The Review considers that any revised definition of insolvency in s 95A should apply equally to collective investment schemes.
38. cf Corporations Law s 436A.

effective way of dealing with the scheme's insolvency. A chargee of the whole, or substantially the whole, of the scheme's property should also be permitted to appoint an administrator.[39]

Implications of scheme operator becoming insolvent

8.14 Where a scheme operator is unable to pay its debts or comes under external insolvency administration (for example, by the appointment of a receiver to its property or by going into liquidation), a temporary scheme operator must be appointed.[40] In relation to trading trusts ALRC 45 recommended that

- the liquidator or administrator of an insolvent company acting as trustee of a trading trust should be able to administer the business or affairs of the company as trustee as well as the business or affairs of the company in its own right and should have power to deal with property held by the company on trust[41]
- any provision in a trust deed allowing for the removal of the company as trustee or the exercise of any power that allows for the removal of the company as trustee should have no effect but there should be an exception to permit a liquidator or administrator to cause the company to resign as trustee.[42]

Those recommendations are appropriate to trading trusts, but not to large collective investment schemes. There may be a significant conflict of interests between the liquidator or administrator of the scheme operator and the investors. For example, the liquidator or administrator might maintain, rather than wind up, the scheme primarily to enhance the value of the indemnity rights of the insolvent scheme operator. Also, one or more of the schemes operated by an insolvent scheme operator may be commercially viable and should be continued. In these circumstances, it may be inappropriate for a liquidator or administrator of an insolvent scheme operator to act as the new scheme operator. To require court approval of a temporary scheme operator would not be unduly expensive or time consuming. The court may, where appropriate, appoint the liquidator or administrator as the temporary scheme operator. To give this discretion to the court would protect against any real or apparent conflict of interest. The Review **recommends** that the liquidator of a scheme operator should not be the liquidator of the operator's schemes unless the court so orders.

39. cf Corporations Law s 436C.
40. See para 14.20.
41. ALRC 45 para 245. ALRC 45 recommended that the provisions relating to trading trusts apply, so far as relevant, to a company under administration: para 271.
42. ALRC 45 para 258.

9. Compliance

Introduction

9.1 This chapter deals with compliance risk. This is the most significant risk that a regulatory regime for collective investment schemes must deal with.[1] Dealing adequately and in a cost effective way with compliance risk is the central element of the regulatory regime the Review recommends for collective investment schemes. This chapter and chapter 10 make recommendations to address that risk.

The importance of compliance with the law

Widespread view

9.2 Submissions and consultations revealed a widespread view that the focus of the regulation of collective investment schemes should be on compliance with the law and with the scheme's constitution.[2] The Review agrees. It is important that the conditions under which people invest in a scheme are met. Regulation should be directed at minimising compliance risk.

Displacement of responsibility

9.3 The Review was told, particularly by trustee companies, that, under the current regime regulating prescribed interest schemes, some management companies tend to use the trustee as a way of determining whether what they propose to do complies with the law and the terms of the trust deed. Rather than taking responsibility themselves for the legality of an investment proposal, they tend to regard a proposal as acceptable if the trustee approves it. They may also regard a claim for expenses as acceptable if they can get it approved by the trustee. This attitude arises in large part because of the presence of the trustee, which may do little to encourage managers to take responsibility themselves for seeing that the law and the scheme's constitution are adhered to.

Addressing compliance risk

Responsibility for, and focus on, compliance

9.4 There are two important elements in addressing compliance risk. First, it must be very clear who has responsibility for ensuring compliance. This is best done by providing that the scheme operator has full responsibility for all aspects of compliance with the law and the scheme constitution. The scheme operator is best

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1. See para 2.8.
2. Submissions from the trustee industry argued that the kind of protection trustees provide, and are most often regarded as providing, to investors is ensuring that the manager complies with the law and with the deed: see, eg, Permanent Trustee Company Limited *Submission* 18 December 1992. The TCA suggested that the focus of a trustee's duty should be to ensure that the operator adheres to the deed, the prospectus and the legislation: TCA *Submission* 10 December 1992.

positioned to ensure that this issue is addressed when the scheme is created and throughout its operation. Secondly, the law must be designed to focus the mind of a scheme operator constantly on that responsibility.

Incentive and responsibility

9.5 Compliance risk will be contained if scheme operators establish and give effect to compliance measures that are reasonably likely to detect in advance and prevent a potential breach of the law or the scheme's constitution. The measures the Review envisages would include rules and procedures to be followed at every stage in the management of the scheme which eliminate, as far as reasonably possible, the risk of mistake, neglect or fraud in the conduct of the scheme, and a system of checks and independent auditing to ensure that those rules and procedures are being complied with. The law should underwrite the desirability of operators implementing such measures. Simply requiring operators to have adequate[3] compliance measures is not, however, the most effective way to achieve this. Operators must also be given an incentive to address the issue of compliance risk and must be made to take responsibility for the compliance measures under which their schemes operate. This incentive can be provided by making it a defence to most prosecutions for breaches of the law that the operator was taking all reasonable measures to prevent relevant contraventions.[4] Encouraging scheme operators to take responsibility for compliance measures can also be achieved by requiring them to certify that the compliance measures under which they will operate are adequate.

Focus on compliance can be achieved by licensing operators

9.6 The need to discharge its obligations and to maintain its commercial reputation should, ideally, provide enough encouragement for a scheme operator to adopt the highest standards of compliance with the law and the scheme constitution. However, to ensure this focus is maintained and to promote investor confidence in the collective investments industry, the law should reflect the centrality of compliance. An appropriate way to achieve this is to license operators, with the focus of the licensing process being the adequacy of their compliance measures. The law should specify a number of matters to which the regulator must have regard when considering the compliance measures proposed in a licence application.[5] Even more importantly, a licensing regime should provide a mechanism for making scheme operators take responsibility for the way in which compliance risk is addressed in their schemes. Scheme operators should have to endorse the compliance measures under which they will operate. Also, it should be a ground for an operator's licence to be revoked that there is a reasonable risk that the law or the scheme's constitution will be breached.

3. 'Adequate' means that are reasonably likely to detect in advance and prevent a potential breach of the law or the scheme's constitution.
4. See ch 15.
5. The process of licensing is discussed more fully in ch 10.

Form of compliance measures will not be prescribed

9.7 The law should not specify what will constitute adequate compliance measures. Rather, the law should place the responsibility on the scheme operator to develop and implement an appropriate set of compliance measures to address a minimum number of mandatory matters. This allows for flexibility — compliance procedures will be adjusted according to the nature and features of individual schemes. This is vital to an efficient and effective regulatory framework, particularly given the wide range of schemes that fall within the definition of a collective investment scheme.

Honesty and solvency relevant to compliance

9.8 The risk of non-compliance with the law and with a scheme's constitution will be higher if the scheme operator or one of its responsible officers has a history of dishonesty. An operator should not be permitted to conduct a scheme if one of its responsible officers has a recent conviction for serious fraud or has recently been subject to a civil penalty for an act of dishonesty. If the operator itself has been convicted of serious fraud or been subject to a civil penalty for an act of dishonesty, its suitability as a scheme operator must be closely scrutinised. The Review makes various recommendations in the context of licensing operators to exclude such corporations and individuals from the collective investments industry.[6] The risk of non-compliance is also likely to increase if the operator of a scheme, or one of its officers, is severely financially constrained. In principle, an individual who has failed to manage his or her own financial affairs successfully should not be given the opportunity to mismanage other people's money while still an undischarged bankrupt. Again, the best way to enforce such restrictions is through the licensing process. The Review makes recommendations about this in chapter 10.[7]

Non-executive directors to improve compliance

Proposal and submissions

9.9 The Review has considered whether there is a role for non-executive directors in reducing compliance risk in collective investment schemes. DP 53 asked whether there should be a requirement for non-executive directors on the boards of scheme operators.[8] Submissions revealed varied views on the effectiveness of non-executive directors in providing control over management and supervision of executive directors. Those in favour of non-executive directors argued that they have fewer possible conflicts of interest and can help to scrutinise management activities and that they would be a 'desirable check and balance' for a scheme operator.[9] Others considered that non-executive directors cannot exercise

6. See para 10.52-10.54.
7. See para 10.52.
8. Issue 4E. Non-executive directors are neither involved in the day-to-day running of the company nor dependent upon that directorship as their main means of livelihood.
9. eg TCA *Submission* 17 December 1992; BT *Submission* 15 December 1992. Evidence in support of independent directors was provided to the Lavarch Committee: see Lavarch Report 5.5.7-5.5.10.

any substantial control as they may face difficulties in getting access to or fully understanding corporate information and they meet infrequently.[10] Two submissions queried the availability of non-executive directors.[11]

Recommendation

9.10 The Review has concluded that non-executive directors would bring to a scheme operator a degree of detached supervision that could enhance the standard of corporate governance of the operator and the schemes it operates. Non-executive directors of corporations are required to exercise reasonable care and diligence in exercising that supervisory function.[12] They could, therefore, significantly reduce the compliance risk of collective investment schemes. To ensure the appropriate degree of detachment, a non-executive director should be subject to two restrictions: he or she should not be, or have been during the previous three years, an employee or executive officer of the scheme operator or of an associate of the operator[13] or hold any shares in the operator or an associate of the operator. The second restriction is warranted because any shareholding in the operator may give a director an incentive to prefer the interests of the operator over those of the investors in the operator's schemes. This may reduce his or her effectiveness as a means of improving compliance. The Review **recommends** that, to enhance compliance with the law and the scheme constitution, at least half of the board of scheme operators should, at all times, be non-executive directors. Breach of this obligation for more than 14 days, without reasonable excuse, should be an offence.[14] The potential problem of not finding enough people willing to act as non-executive directors is reduced as persons may act as non-executive directors for any number of operators.[15]

Custody of scheme property

Issue

9.11 Who holds the scheme property, and under what arrangements, are key factors in any assessment of the compliance risk of a collective investment scheme. The following paragraphs consider whether there should be restrictions on who can

10. The Review notes that in a recent case it was considered reasonable to expect that directors would inform other directors of relevant information uncovered between directors' meetings: *ASC v Gallagher* (1993) 10 ACSR 43.
11. Arthur Robinson & Hedderwicks *Submission* 10 December 1992; ASCPA & ICAA *Submission* 15 February 1993.
12. *AWA Ltd v Daniels* (1992) 7 ACSR 759; *ASC v Gallagher* (1993) 10 ACSR 43.
13. Being a non-executive director for an associate of an operator should not, however, prevent a person becoming a non-executive director for the operator.
14. The reasonable excuse defence might be available where one or more non-executive directors resign, without an immediate replacement, and the proportion of non-executive directors comprise less than half the operator's board. The defence should be available only where all reasonable measures are being taken to fill the vacancy properly.
15. All directors of scheme operators will owe their primary duty to the scheme investors, not to the operator or its shareholders. The law should provide expressly that they must prefer the interests of investors over those of the company if those interests conflict. It should also provide protection against claims by the operator or its shareholders for directors who acted in investors' interests in a situation where those interests differed from those of the company: see para 10.17.

hold legal title to scheme assets (including whether the operator should be permitted to hold them) and ways of separately identifying them. Under current arrangements, the legal title to the assets of a prescribed interest scheme must be held by a trustee or representative or by the investors themselves.[16] The entity managing the scheme is not permitted to hold the assets of the scheme.[17]

Should the operator be able to hold scheme assets?

9.12 ***Proposal and submissions.*** DP 53 proposed that the scheme operator should be able to hold legal title to a scheme's assets. Alternatively, it could engage another party to hold the assets, although the operator would remain ultimately responsible to investors for the way in which those assets are dealt with.[18] The DP also proposed that a scheme operator that holds scheme assets should have to do so for the use and benefit of the investors in the scheme (that is, on trust for the investors) and keep them separate from its own property.[19] Some submissions supported the proposal.[20] Others argued that, to provide protection against fraud by the operator, scheme assets should always be held by an external party.[21]

> The fact remains that separation of physical control from a scheme's [operator] can only serve to reduce the opportunity for misappropriation or fraud because it creates an additional step which a party intending to commit a fraud must take, involving another party.[22]

At least one submission expressed the view that not requiring a separate custodian in all cases risks a decline in investor confidence by moving out of step with overseas arrangements.[23]

9.13 ***Review's view: scheme operator may hold assets.*** Compliance risk will not be eliminated merely because the title to scheme assets is held by someone other than the operator. A bare custodian, for example, will provide little protection against misuse of scheme property because it will be required to deal with the property as instructed by the scheme operator. Requiring an external custodian in all instances would also be unnecessarily rigid. It would impose costs that may well outweigh the benefits in terms of improved compliance. The Review does not consider this necessary or appropriate. Instead, who holds the assets and the obligations, if any, that they have under the arrangement between them and the

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16. This is not prescribed by law. In forming its opinion whether a deed complies with Pt 7.12 Div 5 and the regulations, however, 'the ASC is of the view that it must consider whether . . . (c) the deed effectively provides that all the property to which the scheme relates is vested either in the interest holders on their own account or in the trustee on their behalf throughout the life of the scheme': ASC Policy Statement 23.
17. Unless an exemption is granted from the requirement to have a separate trustee or representative, eg, trustee common funds.
18. Proposal 4.1.
19. Proposal 4.7.
20. eg St George Funds Manager Limited *Submission* 18 December 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; FPAA *Submission* 7 December 1992; MLC Investments Limited *Submission* 17 December 1992.
21. eg Permanent Trustee Company Limited *Submission* 12 November 1992.
22. County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
23. eg Permanent Trustee Company Limited *Submission* 12 November 1992.

scheme operator should be considered as an important factor in determining the adequacy of the scheme operator's compliance measures. Whether compliance measures that involve the operator having custody of scheme assets are adequate will depend on the totality of the compliance measures. The Review is also satisfied that not requiring by statute a separate custodian will not have an adverse impact on Australia's standing in the international financial community.[24] A scheme operator that is permitted to hold scheme assets itself must do so subject to two requirements: it must hold the assets on trust and separately from its own assets.[25]

Scheme operator will hold property on trust for investors

9.14 A scheme operator that holds scheme property must do so on trust for investors. That is, the investors should retain the beneficial ownership of the assets. Where an operator engages a custodian to hold the legal title to scheme assets, the operator should hold on trust for the investors the equitable interest arising under that arrangement. The Review considers that, because of the nature of the activity undertaken, this trust relationship should exist in all collective investment schemes, even those based on contract.[26] This may result in investors in some schemes having a wider range of remedies available than they would otherwise have. The Review **recommends** that the Corporations Law should be amended to provide that, if the operator of a collective investment scheme holds property of the scheme, it will do so on trust for the scheme investors. Schemes in which investors hold the scheme property will not be affected.

Identification of scheme assets held by the operator

9.15 Operators that hold scheme assets must hold them separately from their own assets. Likewise, if an operator holds assets belonging to more than one scheme, they should be separately identified as assets of particular schemes. This will ensure that scheme assets are easily identifiable if a liquidator is appointed to the operator. Currently

> [t]here can be major difficulties for a liquidator in distinguishing an insolvent company's own assets from assets held in trust. Many insolvency lawyers will attest that this is a perennial problem. In the case of a [manager] administering more than one scheme, then absent a custodian, the further difficulty in distinguishing assets owned by different schemes could arise.[27]

24. If an operator wishes to market a scheme directly to foreign investors and judges that the scheme will not be acceptable unless a separate custodian holds the legal title, it is free to engage a custodian. It is far more likely, however, that, if an Australian operator wanted to tap into the savings of foreigners, it would establish a scheme overseas, in accordance with the rules of the host country, with which overseas investors are familiar, and then invest the funds in Australia.
25. See para 9.14, 9.15. If the title to the assets of a scheme is vested in the investors, the question whether the operator or another person appointed by the operator should hold the assets will not arise.
26. The concept of applying trust law principles to contracts is not new. Under the *Life Insurance Act 1945* (Cth) s 38(8), directors of life insurance companies are deemed to be under the same liability in respect of contraventions of the provisions of the section (which deals with the company's statutory funds into which premium income, including that from investment bonds (ie investment contracts), is paid) as if they had been trustees under a trust.
27. Minter Ellison Morris Fletcher *Submission* 19 November 1992.

It was suggested in submissions that, without the additional requirement of an external custodian, scheme assets could not be kept bankruptcy remote. The Review does not agree. The important element in keeping scheme assets remote from the bankruptcy of a scheme operator is the ability to identify them clearly as assets of a collective investment scheme. This identification could be achieved without the assets being held by a separate party — by having a proper ledger system and by identifying the scheme[28] on all relevant documents evidencing title and on all accounts holding cash of the scheme. It would then be clear to a liquidator appointed to a scheme operator, that the operator is not the beneficial owner of the assets. The Review therefore **recommends** that, if a scheme operator holds scheme assets, it must identify them in such a way that they are clearly property of a particular collective investment scheme. Where the title to property is registered on a public register, the relevant State and Territory laws should be altered to allow the register to reflect ownership by a particular scheme. It will be necessary to ensure that identifying property in this way does not affect a purchaser's ability to take good title. Where there is no registration for particular kinds of property, the scheme operator's records will have to reflect the ownership of the property. To assist in keeping scheme assets separate and identified, the Review also **recommends** that application forms for interests in a collective investment scheme should direct that cheques be drawn in favour of the scheme operator on account of the particular scheme.[29]

Operator may use external custodian

9.16 A scheme operator should be able to appoint an external custodian if it wishes. It may do so for commercial reasons[30] or as part of its stated compliance measures. The arrangements under which any external entity is engaged to hold the legal title to scheme assets, including whether that entity should be required to identify the assets separately, will be an integral part of an operator's compliance measures.[31] As such it will be considered by the regulator in the licensing process.[32] Scheme operators may be able to reduce costs by using an external custodian if the external custodian does not have to identify assets separately.[33] The Review does not consider there is a need to restrict the entities that can be used as external custodians. Also, whether an external custodian will hold the assets for the operator or the investors will be determined by the terms of the arrangement between the operator and the external custodian. There is no need to prescribe this.

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28. By name and registration number: see para 4.9.
29. Corporations Regulations reg 7.12.15(6)(bb) prescribes a covenant that the management company will, in all prospectuses and other representations relating to the prescribed interests, direct that all cheques and other payment orders in respect of applications for prescribed interests be drawn in favour of the trustee or representative on account of the particular prescribed interest concerned.
30. It may consider, for example, that the scheme will be more attractive to investors if an entity other than the operator has custody of the assets. It may also find it too much of a burden or inconvenience to hold the assets itself.
31. Currently, a custodian trustee holds legal title to scheme assets in its name. The assets are not separately identified as scheme assets except in the internal records of the custodian trustee.
32. See para 10.45 for discussion of ASC's consideration of custody arrangements in the licensing context.
33. See para 9.15 for requirement to identify scheme assets. The ASC will be able to require an external custodian to identify assets separately by imposing a condition to that effect on an operator's licence: see para 10.46.

Liability of the parties — scheme operator primarily liable

9.17 DP 53 proposed that a person operating a scheme should not be able to assign responsibility. However, one submission suggested that an operator who engaged an independent custodian should be able to assign to the custodian the risk involved in holding assets of a collective investment scheme.

> Assigning the risk to a custodian would ensure that proper contractual arrangements are entered into between the [operator] and the custodian with clear definition of responsibilities of the respective parties. . . . [W]ithout a provision to contractually assign risks to custodians, there is a barrier to entry into the industry for smaller fund managers . . . Investors' interests are best served by promoting competition amongst fund managers and, for this purpose, any proposal which limits entry by creating barriers to entry should be avoided.[34]

The Review affirms its view in DP 53. The scheme operator should always be liable. It should be no defence to a claim arising out of a contravention of the law or the scheme's constitution in relation to a dealing with scheme property that the operator had engaged a custodian to hold the property. That alone should not be enough. Managing other people's money is a responsibility not to be taken lightly and scheme operators must carry the responsibilities associated with this activity. In some cases, under the Review's recommendations, it will be a defence that the operator was taking reasonable compliance measures.[35] These may involve a custodian but the fact that a custodian has been used will not determine the matter. The Review's recommendations do not deal with claims in negligence, that is, claims not based on a contravention of the statute. How these claims are determined against the operator or the custodian is best left to the general law.

Role of person engaged by scheme operator to assist with compliance

9.18 A scheme operator may engage a person with the appropriate capacity and experience to undertake all or some compliance measures.[36] Many operators may continue to engage the services of a trustee company. The role of the trustee company in each case will be determined by agreement between the scheme operator and the trustee company.[37] What its relationship with the investors will be, in particular whether it will have a relationship of trustee and beneficiary, will also be determined by that agreement and the general law. This will provide schemes with a degree of flexibility they do not have now. The scheme operator will always retain primary liability regardless of the compliance measures. If a trustee company or other person supplying compliance services breaches its contract with the operator and that breach causes loss to investors, the operator will remain liable to investors. It may, however, be able to seek indemnity from the

34. County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
35. See para 10.40, 15.4, 15.5.
36. Whether any custodian engaged to hold the legal title to scheme assets is also engaged to perform a compliance role will be a decision for the parties.
37. One scheme operator may wish a trustee company to perform a large part of its compliance measures; another may be capable of doing most compliance tasks itself and merely have the trustee company hold the legal title to the scheme assets.

trustee company or other person under the contract between it and that person.[38] In some circumstances, for example, if the trustee company or person engaged was negligent or fraudulent, that company or person, as well as the scheme operator, may be directly liable to investors at common law. At present, by contrast, it may be unclear whether the trustee or the manager is liable for a particular loss and allocating liability for loss is time consuming and expensive.

Other matters relevant to compliance

Appropriate sanction mechanisms

9.19 An important aspect of a regulatory regime that is directed first and foremost at achieving a high degree of compliance is an appropriate sanctions regime. Breaches of the obligations with which a scheme operator must comply must be dealt with promptly and in an appropriate way. The Review has taken care to recommend a sanctions regime that will provide incentives to comply and that will be effective.[39]

Licensing by ASC and monitoring by ASC and auditors

9.20 The focus on compliance is to be achieved primarily by requiring operators to be licensed by the ASC and requiring the ASC to consider the adequacy of an operator's compliance measures in assessing whether a licence should be granted. The ASC will also have continuing surveillance powers so as to monitor scheme operators and, particularly, the degree to which the compliance measures specified as conditions of their licences are observed. Auditors too will play a role in supervising and monitoring scheme operators.[40]

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38. A scheme operator may be able to take action against a trustee company or other person pursuant to the agreement, whether or not any claim was made by investors against the scheme operator.
39. The details of this regime are discussed in ch 15.
40. Details of the regulatory and monitoring roles of the ASC and auditors respectively are discussed in ch 14 and ch 6.

10. The scheme operator

Introduction

10.1 The quality of a scheme operator and the way in which it conducts the affairs of a scheme will have a strong bearing on the scheme's success or failure. This chapter deals with the duties scheme operators and their officers should owe to scheme investors, the financial and structural controls on scheme operators and the licensing of operators.

Scheme operators to be companies

10.2 Under the existing law, only a public corporation may issue prescribed interests.[1] DP 53 suggested that there was no need for this requirement.[2] A number of submissions disagreed.[3] It was said that there can be problems with unincorporated fund managers if different individuals are involved throughout the life of the scheme. By contrast, an incorporated body remains even with a change of directors or other managerial personnel. Also, requiring managers to be incorporated would allow the regulator to take advantage of existing reporting mechanisms.[4] The Review has concluded that, given the difficulties of dealing with unincorporated groups because of changes in personnel, the ASC will be better able to supervise operators of collective investment schemes if they are corporations. Accordingly the Review **recommends** that only companies incorporated under the Corporations Law may apply for a scheme operators licence.[5]

Duties of scheme operators and their officers

Several sources of obligations

10.3 The operator of a collective investment scheme will be subject to obligations from three sources — the Corporations Law, the general law and the constitution of the scheme. Statutory obligations should be clearly expressed and be of general application. This will help to focus a scheme operator's attention on its responsibilities.

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1. Corporations Law s 1064.
2. Para 4.16.
3. eg IFA *Submission* 30 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; Attorney-General's Department *Submission* 21 December 1992.
4. Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992. The Review recommends that scheme operators should have to lodge annual audited accounts with the ASC and make them available upon request to investors: see para 5.28.
5. The Review recommends that all scheme operators be licensed: see para 10.35. If it is decided in the future that companies registered in New Zealand ought to be allowed to establish and market collective investment schemes in Australia, appropriate modification to the law may be required.

Imposing general obligations by statute

10.4 ***To ensure an appropriate relationship between the scheme operator and investors.*** Collective investment schemes may take various legal forms.[6] In all cases, however, the operator and its directors will be in a fiduciary relationship with investors. The basic fiduciary relationship between operators and investors and the fundamental obligations of operators should be common to all schemes and incapable of variation through scheme constitutions. This can be done most effectively by imposing a minimum common set of duties through the Corporations Law.

10.5 ***DP 53 proposal and submissions.*** DP 53 suggested a set of minimum statutory obligations for all operators and their directors.[7] Many submissions supported the proposal.[8] Others did not.

> [W]e believe that the Discussion Paper does not consider the effect of statutory intervention on a constantly developing body of equitable doctrine. The enactment of a 'statutory fiduciary duty' creates an opportunity for confusion with the analogous obligation imposed by equity and may inhibit the development of the equitable doctrine. In fact it has created some of the problems which the industry presently faces . . . [T]he benefit (if any) of creating a statutory duty where the relevant obligation is already well established at general law is unclear.[9]

There was concern too that it may not be possible to draft these duties with sufficient clarity to be useful.[10]

10.6 ***Recommendation.*** It should be made abundantly clear that responsibility for a collective investment scheme lies with the operator of the scheme. To assist in highlighting that responsibility the Corporations Law should set out duties common to all operators of collective investment schemes, regardless of their legal structure. This will

- lead to a better understanding and awareness of the obligations of operators
- enhance the ability of the regulator to enforce them
- eliminate the possibility that these obligations may be eroded or avoided by the terms of the scheme's constitution.

The Review acknowledges the concerns expressed in submissions about including in legislation duties which presently exist only at general law. On balance, the Review considers that the advantages outweigh the possible detriments. The Corporations Law already imposes some general fiduciary duties on directors and officers, which reflect or supplement duties imposed by the general law.[11] The Review **recommends** that the Corporations Law should state clearly a set of

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6. eg trusts, partnerships, limited partnerships, contractual arrangements.
7. Proposals 4.5, 4.7.
8. eg Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992.
9. Freehill Hollingdale & Page *Submission* 8 December 1992.
10. eg T Valentine *Submission* 5 November 1992.
11. eg requirements to act honestly (Corporations Law s 232(2)) and to exercise a reasonable degree of care and diligence: s 232(4). See also s 232(11).

obligations for operators and their officers which may not be modified or excluded by a scheme's constitution. It has already recommended in chapter 4 that the system of prescribed covenants be abolished and that obligations should be imposed on scheme operators directly by the law.[12] These obligations should be in addition to the duties scheme operators owe to investors at general law. The duties of officers of operators should be in addition to duties they owe to the company at general law or under the Corporations Law s 232.

Duties imposed on scheme operators

10.7 ***Duty to act honestly.*** The obligation to act honestly is fundamental.[13] It should apply to operators of all collective investment schemes, whatever the scheme's legal structure. The Review **recommends** that the Corporations Law should impose an obligation on the operator of a collective investment scheme to act honestly in respect of the scheme.[14]

10.8 ***Duty to act in the interests of investors.*** Investors in collective investment schemes rely heavily on the operator to act in their best interests. Nevertheless, there will often be a potential for conflict between their interests and those of the operator. This may arise over the fees and charges payable to the operator or the use of scheme property for dealings with parties related to the operator. DP 53 proposed that the law should impose on operators a duty to avoid conflicts of interest.[15] A number of submissions argued that this proposal was neither realistic nor desirable.[16] Conflicts of interest between scheme operators and investors are inevitable. The Review has concluded that the appropriate formulation of the test is that operators must prefer the interests of investors over their own interests where any conflicts arise.[17] The Review **recommends** that the Corporations Law should impose an obligation on the operator of a collective investment scheme to exercise its powers and perform its duties as operator in the best interests of investors rather than in its own, or anyone else's, interest, if that interest is not identical to the interests of the scheme investors. This duty should be complemented by specific rules for related party transactions.[18]

10.9 ***Expenses and charges not to be paid otherwise than in accordance with the scheme constitution.*** In consultations with the Review, trustees emphasised that they spend a considerable amount of time assessing whether claims by managers

12. See para 4.4.
13. The Corporations Law imposes on officers an obligation to act honestly in exercising the powers and discharging the duties of the office: s 232(2).
14. See ch 15 for discussion of the circumstances in which a breach of the obligations set out in this chapter will be attributed to the operator.
15. Proposal 4.7.
16. Freehill Hollingdale & Page *Submission* 8 December 1992; Arthur Robinson & Hedderwicks *Submission* 10 December 1992; IFA *Submission* 1 December 1992; MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
17. This reflects the fiduciary obligation which the general law imposes on persons in the position of the operator, eg, the general principle that no one who has a fiduciary duty to perform shall place himself or herself in such a position that his or her interest will, or even may, conflict with that duty and that, if interest and duty do conflict, interest must give way: RP Meagher QC & WMC Gummow *Jacobs' Law of Trusts in Australia* 5th ed 1986, 416.
18. See para 10.25, 10.26.

for reimbursement of expenses should be paid. It was suggested that many claims are made for unauthorised expenses. DP 53 proposed that operators of collective investment schemes should be subject to a duty not to make a profit from a collective investment scheme other than as provided for in the constituting document. Several submissions expressed concern about this proposal. For example, one was concerned that the payment of two sets of fees, for administration and funds management, in a master trust arrangement would constitute a breach of trust.[19] Another was concerned that investing a scheme's money in another scheme operated by the same operator would effectively be prohibited.[20] The Review no longer considers that a duty regarding expenses and charges needs to be stated expressly given other relevant duties, for instance, to observe the scheme's constitution and not to make improper use of its position. An alternative suggested to the Review was that scheme operators should be subject to a fixed fee instead of a management fee plus expenses. The Review does not consider that appropriate as various expenses that should be paid by the scheme may not be foreseeable when fixing the fee. Instead, the Review **recommends** that it should be an offence for an operator to make payments out of the scheme property on account of expenses or charges, either for itself or for anyone else, except in accordance with the scheme's constitution. A scheme's constitution should state the basis on which the scheme operator will be remunerated and clearly state the basis for payment of expenses. This information should be disclosed in the scheme prospectus.[21]

10.10 ***Costs of hiring an investment manager or investment adviser.*** A scheme operator's fee should reflect its responsibility for investing the assets of the scheme. DP 53 proposed that, if a scheme operator hires an investment manager to perform all or part of that function, the costs involved should be borne by the operator, not the scheme.[22] This was on the basis that the scheme will already have paid the operator a fee for managing the scheme. The proposal received widespread support.[23] The Review **recommends** that an operator should not be able to recover from scheme assets the cost of hiring an investment manager or an investment adviser.

10.11 ***Duty to keep scheme property separate from the operator's property.*** The principle that trust funds should always be kept separate from the assets of the trustee applies equally to collective investment schemes and traditional trusts. The Corporations Law presently requires that there be a separate trustee or representative to hold the scheme property on trust for the investors, unless title remains with investors. The same principle can be applied by requiring scheme operators to separate scheme assets from their own. The Review **recommends** that the Corporations Law should impose an obligation on operators of schemes in which the investors do not retain title to the scheme's assets, to keep the scheme's

19. Macquarie Investment Management Limited *Submission* 24 November 1992.
20. St George Funds Manager Limited *Submission* 18 December 1992.
21. See para 5.14. The scheme's Management Expense Ratio for the previous five years will also be required to be disclosed in the prospectus: see para 5.14.
22. Proposal 5.13.
23. eg IFA *Submission* 1 December 1992; ISC *Submission* 12 November 1992; JK Denyer *Submission* 3 November 1992; MLC Investments Limited *Submission* 17 December 1992; TCA *Submission* 17 December 1992.

assets separate from their own assets. This obligation will in most cases be satisfied by compliance with other, more specific, requirements, for example, the requirement that operators identify scheme assets in a way that clearly marks them as scheme assets.[24]

10.12 *Duty to treat investors equally and fairly.* The duty that a trustee has to act fairly when dealing with beneficiaries whose rights are dissimilar is well established. Approved deeds for prescribed interest schemes must include a covenant binding the trustee and the manager to treat the holders of interests of the same class equally and to treat the holders of interests of different classes fairly.[25] The Review **recommends** that this obligation should be imposed directly by the Corporations Law on operators of all collective investment schemes.

10.13 *Not to make improper use of information or position.* The Corporations Law imposes a direct obligation on a director of a company not to make improper use of information that he or she receives as a director, or of his or her position as a director, to gain an advantage for himself or herself or for anyone else, or to damage the company.[26] This duty is based on the principle that a director should not profit from his or her position in the company. Trust law imposes a similar duty on a trustee, for the benefit of the beneficiaries in the trust.[27] Given the fiduciary nature of the relationship between the operator and the investors in a collective investment scheme, the law should impose a similar obligation on the operator itself, for the benefit of the investors. The Review **recommends**, therefore, that the Corporations Law should provide that an operator must not make improper use of information that it gets as operator of a particular scheme, or of its position as operator, to gain an advantage for itself or for any other person or to cause detriment to the investors in the scheme. This obligation should extend to a company that was the operator of a scheme.

10.14 *No statutory duty to observe the constitution of the scheme.* The recommendations in this report are directed largely at reducing to an acceptable level the risk that an operator will not comply with the law or the constitution of its collective investment scheme. The operator, by establishing and marketing a scheme with a particular constitution, in effect promises investors that it will adhere to the constitution's requirements. DP 53 proposed that the Corporations Law should include an obligation to observe the constituting document of the scheme.[28] The Review no longer considers, however, that it is appropriate to place this obligation in statute. Breach of the scheme constitution should not be an offence because it is inappropriate to have the ASC prosecuting breaches of a private agreement. Including in the law the obligation to observe the scheme constitution

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24. See para 9.15.
25. Corporations Regulations reg 7.12.15(1)(f)(ii).
26. Corporations Law s 232(5), (6).
27. A trustee must not abuse its position by making it a means of profit or benefit to itself or any third party: *Stuart v Kingston* (1924) 34 CLR 394, 401. A trustee must account for benefits or gains obtained in circumstances where there was an actual or significant possibility of a conflict between personal interest and fiduciary duty and must account for any benefit or gain obtained or received by reason of or by use of its fiduciary position or of opportunity or knowledge resulting from it: RP Meagher QC & WMC Gummow *Jacobs' Law of Trusts in Australia* 5th ed 1986, 421.
28. Proposal 4.7.

is not necessary to enable investors to enforce the constitution. Investors will be able to enforce the constitution at general law. The ASC will also be able to enforce a scheme constitution either by representative action[29] or by seeking a compliance order from the court.[30] The Review does not recommend, therefore, that the Corporations Law should expressly impose an obligation on a scheme operator to adhere to the scheme's constitution.

Duties imposed on officers of operators[31]

10.15 ***Proposal and submissions.*** The Review has recommended that all scheme operators should be companies incorporated under the Corporations Law.[32] The directors of an operator will, therefore, owe duties to the company.[33] DP 53 proposed that the law should require each director of an incorporated operator to owe to scheme investors the same general duties that the Review proposed should be owed by the operator itself.[34] This proposal was designed to overcome a gap in the existing regulatory framework for collective investment schemes.

> There is nothing directly corresponding to the criminal and civil sanctions imposed on directors of corporate enterprises by way of statutory duties as is found, for instance, in Part 3.2 of the Law. Obviously the directors of the management company are subject to these provisions, but they extend only so far as their relationship to that company and not to the trust scheme itself. There are certain requirements imposed by the statutory covenants, and certain liabilities for contravention . . . But these do not match the standards expected of directors in relation to the corporate enterprise.[35]

There was considerable support for this proposal.[36] Several objections were raised, however.[37] First, the proposal was criticised on the ground that it would amount to lifting the corporate veil.

> In suggesting that directors of the [operator] assume the same obligations towards investors as the [operator] itself, the [Review] is in effect proposing that the corporate veil be lifted and creating a new regime at odds with the existing law. We do not think that it is necessary or desirable to do so.[38]

29. See para 14.22.
30. See para 14.19.
31. 'Officers' means directors, the secretary and other executive officers. Executive officer' is defined in the Corporations Law s 9 as a person by whatever name called and whether or not a director . . . who is concerned, or takes part, in the management of the body.
32. See para 10.2.
33. Both at general law and under the Corporations Law: eg Corporations Law s 232. Although the position is not yet clear, it is argued by some that, at common law, directors also owe duties to shareholders.
34. Proposal 4.8. The term 'essential' is not used in this report because it does not recommend that there be duties from which the ASC cannot grant an exemption.
35. RA Hughes *The law of public unit trusts* Longman Professional 1992, 46.
36. eg Macquarie Investment Management Limited *Submission* 24 November 1992; FPAA *Submission* 7 December 1992; TCA *Submission* 17 December 1992; Attorney-General's Department *Submission* 21 December 1992.
37. eg Australian Film Commission *Submission* 7 January 1993; Arthur Robinson & Hedderwicks *Submission* 10 December 1992; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992.
38. Arthur Robinson & Hedderwicks *Submission* 16 December 1992.

Secondly, it was said that placing more onerous duties on directors would discourage people from accepting directorships, particularly independent directorships.[39] Thirdly, some submissions suggested that conflicts may arise between the duties that directors owe to the company and those that they owe to investors in schemes operated by the company.[40]

10.16 ***Imposing duties on officers.*** Officers of a scheme operator should pay close attention to the interests of the investors in the schemes operated by that company. They should prefer the company's interests to their own and prefer the investors' interests to the company's. Under the general law, the directors of a company owe fiduciary obligations to the company as a whole.[41] The Review considers that investors should have obligations owed to them by the officers of the operator. Investors should be able to take action against officers to enforce these rights directly, without first proceeding against the company. The nature of the rights should be modelled on the Corporations Law s 232. The precise form of the recommendations follows the provisions in the Corporations Law s 232, so that officers will not face additional kinds of liability under the proposal.

10.17 ***Conflict between duties to the operator and duties to investors.*** Officers of scheme operators will continue to owe to the operator the duties set out in the Corporations Law s 232. They will, consequently, owe duties both to the operator and to investors. Where any conflict arises, the latter duty should prevail. The Review **recommends** that this should be expressly provided for in the Corporations Law, and that officers should be given statutory protection from claims by the operator or its shareholders arising from any loss they suffered in consequence of officers complying with their paramount duties to investors.

10.18 ***Duty to act honestly.*** The Review **recommends** that the Corporations Law should impose on officers of scheme operators the duty to act honestly in all matters relating to the scheme.[42]

10.19 ***Duty to exercise reasonable care and diligence.*** The Review **recommends** that officers of scheme operators should, in exercising their powers and discharging their duties in respect of the scheme, exercise the degree of care and diligence that a reasonable person in a like position would exercise in similar circumstances.[43]

10.20 ***Duty to act in the interests of investors.*** The Review **recommends** that the Corporations Law should impose on officers of scheme operators the duty to act in the interests of investors and not in the interest of themselves, the operator or any other person where those interests are not identical to those of investors.

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39. St George Funds Manager Limited *Submission* 18 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992.
40. eg Freehill Hollingdale & Page *Submission* 8 December 1992.
41. Including duties to act in good faith, to avoid a conflict of interest and not to make improper use of their office.
42. See Corporations Law s 232(2).
43. This recommendation is modelled on the obligation to which officers are subject under the Corporations Law s 232(4). The Review notes the distinction being drawn by the courts in applying that obligation to executive and non-executive directors and other officers: see *AWA Ltd v Daniels* (1992) 7 ACSR 759; *ASC v Gallagher* (1993) 10 ACSR 43.

10.21 ***Not to make improper use of information or position.*** The Review **recommends** that the Corporations Law should prohibit an officer of a scheme operator from making improper use of information gained by virtue of his or her position as officer, to gain an advantage for himself or herself or for another person, or to cause detriment to the investors in the scheme.[44]

10.22 ***Duty to ensure that the scheme operator complies with the law.*** The Review **recommends** that an officer of an operator should be under a statutory duty to take all reasonable steps to ensure that the operator complies with all its obligations.

Related party transactions

10.23 ***Current law.*** The Corporations Law Pt 3.2A regulates the circumstances and manner in which a public company, and other entities it controls, may provide financial benefits to any of its directors or other related parties.[45] Its purpose is to protect public company shareholders against the possibility that the value of their investment will be eroded by non-arm's-length transactions. Investors in collective investment schemes need similar protection. At present a number of statutory covenants prohibit or regulate various transactions whereby trustees, management companies or their associates, might receive benefits from the assets of prescribed interest schemes.[46]

10.24 ***Proposal.*** DP 53 sought comment on whether the regulatory principles in the Corporations Law Pt 3.2A should apply to collective investment schemes. The majority of submissions favoured this approach.[47] One submission, however, was concerned that this would result in investors being able to vet the salaries of directors of scheme operators.[48] The related party provisions would not, however, be relevant to the payment of directors of the scheme operator because they would be paid by the operator, not by the scheme.

44. cf Corporations Law s 232(5), (6).
45. Corporations Law Part 3.2A applies in relation to public companies from 1 February 1994.
46. Corporations Law s 1069(1)(g); Corporations Regulations reg 7.12.15(1)(d); 7.12.15(2)(b); 7.12.15(6)(k); 7.12.15(7)(c). See also NCSC Release 128 (eg para 110). This release is currently under review by the ASC.
47. eg T Valentine *Submission* 5 November 1992; TCA *Submission* 17 December 1992; FPAA *Submission* 7 December 1992; Hall Chadwick *Submission* 21 December 1992.
48. IFA *Submission* 1 December 1992.

10.25 ***Recommendation.*** The Review **recommends** that the principles in the Corporations Law Pt 3.2A, adapted for collective investment schemes,[49] should regulate transactions where a scheme operator, its associates[50] or any other related party[51] ('interested parties') could receive a financial benefit[52] from dealings involving scheme assets. These transactions should include:

- scheme assets being invested in an interested party or in a scheme operated by an interested party
- an interested party selling or leasing its property to the scheme
- an interested party acquiring or leasing scheme assets
- scheme assets being lent to, or provided as security for, an interested party
- debts or other obligations owed to the scheme by an interested party being forgiven, released or waived in whole or in part, or its lending terms varied.

Following the principles in Pt 3.2A, and taking into account the concerns expressed in submissions, the Review **recommends** that various transactions should be exempted. These are

- benefits provided to interested parties as scheme investors, if the payment is authorised by the scheme constitution or by the Corporations Law and does not constitute unfair discrimination[53]
- benefits provided on the same terms and conditions as would be provided to a non-interested party ('arm's-length' transactions)[54]
- benefits paid under a court order.[55]

The Review **recommends** that, subject to any prohibition or additional restriction in the scheme's constitution,[56] a non-exempt related party transaction should be permitted only if it is agreed to by a prior resolution of a simple majority of

49. Pt 3.2A itself should not apply to the giving of benefits out of scheme property. The Review has drafted special provisions to apply to collective investment schemes. This will avoid the implication arising from the permissive way Pt 3.2A is drafted, that certain payments are allowed despite restrictions to the contrary in a scheme's constitution.
50. Associates include all related bodies corporate: Corporations Law s 11. 'Closely held' and 'child' entities of the scheme operator should not be excluded. The rationale for their exclusion in Pt 3.2A, merely that they do not involve the transfer of a public company's resources to an entity outside its control, does not apply under the different structure of collective investment schemes.
51. cf Corporations Law s 243F.
52. cf Corporations Law s 243G.
53. cf Corporations Law s 243PA.
54. cf Corporations Law s 243N. This will address the concern raised in one submission about scheme operators that undertake other commercial operations. It gave the example of a scheme operator having a separate corporate advisory division which stood to receive a success fee for the takeover of another company. As a result of a favoured bid price, the scheme managed by the scheme operator sold its shares in that company. It might be argued that the scheme operator helped its corporate advisory division to achieve its success fee and thus received a benefit from a transaction involving scheme assets: Macquarie Investment Management Limited *Submission* 24 November 1992.
55. cf Corporations Law s 243PB.
56. It is not clear what application the provisions of Pt 3.2A have to companies operating collective investment schemes. On one interpretation provisions that allow certain payments to be made could override restrictions in a scheme constitution.

disinterested investors, provided they have been fully informed about the transaction and its likely impact upon the scheme.[57] The ASC must be given the opportunity to comment on the transaction before it is considered by investors.[58] A scheme operator and any other persons involved in a breach should be subject to criminal or civil liability under the civil penalty provisions.[59]

10.26 ***Retirement benefits for operators.*** The Corporations Regulations prescribe a covenant that the trustee or management company will not accept a payment in relation to retirement from office that has not been approved by the votes of the holders of 50% or more of the value of the prescribed interests.[60] The Review supports the principle behind this covenant. It **recommends** that investor approval should be required for the giving of any direct or indirect payment or other benefit from scheme assets to any person in relation to the retirement from office of the scheme operator or any of its officers, including employees. Approval should require the affirmative vote of the holders of more than 50% of the value of the voting interests in the scheme.

Financial stability of scheme operators

A capital requirement

10.27 ***DP 53 proposal — no capital requirement.*** DP 53 raised the issue whether scheme operators should, in all or some circumstances, be subject to a minimum capital requirement. The DP noted that a capital requirement might be justified on any of the following grounds:

- it could provide some indication of the capacity of the operator to conduct funds management operations and to continue as a going concern ('skill money')
- it could provide evidence of the commitment by the operator to its scheme management activities ('hurt money')
- it could be a pool of funds for investors who succeed in litigation against an operator for breach of duty ('comfort money').

DP 53 concluded that a capital requirement would not necessarily serve any of these purposes well enough to warrant its imposition.[61]

57. cf Part 3.2A Div 5; s 243ZF.
58. cf Corporations Law s 243W.
59. Some consequential amendments will need to be made to the Corporations Law Part 9.4B, for instance, any compensation recovered under Pt 9.4B Div 5 should be treated as scheme assets. The exemption from liability for the public company under the Corporations Law s 243ZE is intended to ensure that the interests of its shareholders are not affected. There is no equivalent rationale for exempting a scheme operator from liability, given that the operator would not have any recourse against the assets of the scheme.
60. Corporations Regulations reg 7.12.15(1)(d).
61. See DP 53 para 5.17-5.23. The Review proposed that the operator of a collective investment scheme should not have to have a prescribed amount of capital if it did not trade on its own account: proposal 5.7. It raised as an issue whether operators that do trade on their own account should be subject to a capital requirement: issue 5E.

10.28 ***Submissions and consultations.*** Some submissions supported the proposal for no capital requirement.[62] Many criticised it, however, principally on the ground that scheme operators would not have to show evidence of commitment to the funds management industry.[63]

> We strongly contend that investors' interests are not well served by not having a minimum capital requirement for [operators]. A minimum capital requirement is demonstration of [an operator's] commitment to the industry, and of its substance and credentials to perform collective investment responsibilities. It also offers investors an added degree of security and is a sensible fiduciary discipline on [operators] who would not want to expose their capital base.[64]

It appears that an element of comfort is gained from a capital requirement, despite widespread acknowledgment that any amount chosen will be arbitrary and, for some schemes, inappropriate. A capital requirement is also seen by many as some protection against institution risk.

10.29 ***Addressing institution risk.*** Institution risk, identified in chapter 2 as the risk that the operator of a collective investment scheme will collapse, is not addressed directly in the existing regulation of prescribed interest schemes. The ASC may impose financial conditions and restrictions on a manager by way of conditions on its dealers licence.[65] It usually imposes a condition that surplus liquid funds of $50 000 (or net tangible assets of $20 000), or 5% of adjusted liabilities, must be maintained at all times.[66] Given that the amount of assets under management, even in a medium size unit trust, can be several million dollars, and that very few (if any) managers operate only one scheme, the protection such a control affords may not be significant.

10.30 ***Survival of the scheme not enough.*** The Corporations Law deals with institutional risk by providing that the trustee or representative may manage a scheme and arrange for a replacement manager if the original manager collapses, Accordingly, institution risk is not seen by some participants in the collective investments industry as a major concern. However, the identity of the manager may have been a significant factor in investors' decision to choose that particular scheme. Consequently, they are interested in the fate of their preferred manager. The Corporations Law only provides a mechanism that enables the scheme to continue. The Review's recommendations about appointment of temporary scheme operators also provide a mechanism to enable schemes to continue in the event that the scheme operator collapses. However, they do not do anything to reduce the risk of this event occurring. The Review considers that it is appropriate that the law

62. eg County NatWest Australia Investment Management Limited *Submission* 18 December 1992; Law Council of Australia *Submission* 16 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; Credit Union Services Corporation Limited *Submission* 27 November 1992; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992.
63. eg National Mutual *Submission* 3 December 1992; T Valentine *Submission* 5 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; MLC Investments Limited *Submission* 17 December 1992; TCA *Submission* 17 December 1992.
64. MLC Life Limited *Submission* 18 December 1992.
65. Corporations Law s 786(2)(c).
66. NCSC Release 333 para 78, which has been adopted by the ASC.

address institution risk. The Corporations Law should require scheme operators to meet a minimum capital requirement for two reasons. First, it would provide the proprietors of a scheme operator with some incentive to make sure the operator did not collapse. A minimum capital requirement would also help to avoid the situation where an operator with little or no financial substance, and which is not guaranteed by its parent company, contracts the management of a scheme to its well-capitalised parent company (which will benefit from the arrangement through the fees it receives). The operator will be responsible for the scheme, but that will be little comfort to investors who may be unable to recover anything of substance from it. Nor would they be able to seek payment from the parent company.[67] Investors could suffer. The scheme operator and its parent company may lose nothing but (perhaps) their reputations. Several submissions addressed such a possibility.[68] Secondly, a capital requirement would provide at least some assets against which investors could claim if the operator is held liable for loss suffered by investors.

10.31 ***A minimum capital requirement.*** The Review **recommends** that the Corporations Law should impose a minimum capital requirement on scheme operators. The level of capital required should be calculated by reference to the total value of the assets of the operator's schemes. After consultations and submissions on this matter, the Review considers that the capital requirement should be set at 5% of the value of the assets of all schemes operated by the operator, subject to a minimum of $100 000 and a maximum of $5m.[69] 'Capital' should mean the net value of the scheme operator, that is, the book value of the property that the operator owns beneficially less the operator's actual and contingent liabilities. For the purposes of calculating an operator's net value, interests in a scheme operated by the operator, or an associate of the operator, should not be counted. The 'value of scheme assets' should mean their accounting or book value.[70] The relevant figures should be drawn from each scheme's most recent financial statements.[71] For a scheme operator responsible for more than one scheme, the value of each scheme's assets should be added together to determine the minimum level of capital required, although this may involve calculations concerning schemes that have different balance dates. There may be some measurement error due to book values being out of date, but this is the most appropriate procedure on cost-benefit grounds. A scheme operator should not commit an offence immediately its capital level falls below the statutory

67. The scheme operator would be unlikely to seek an indemnity from the parent company. However the ASC could act on behalf of the scheme operator, with or without its consent, to sue the investment manager: see ch 14.
68. eg Permanent Trustee Company Limited *Submission* 12 November 1992.
69. eg a scheme operator with schemes that have a total of $6m worth of assets would need $300 000 (5% of $6m) capital.
70. A scheme operator would have incentives to reduce funds under management by adopting asset-reducing valuation practices. Elsewhere in this report, the Review recommends that accounting standards for collective investment schemes should be determined by the Australian Accounting Standards Board: para 5.32.
71. The Review recommends that the financial statements of a collective investment scheme should be prepared on a half-yearly basis: para 5.31.

requirement. It should, however, be required to notify the ASC promptly. The Review **recommends** that it should be an offence for a scheme operator to have a capital level below $100 000 or to have, for a period of 14 consecutive days, capital less than that required.

Scheme operator not to guarantee or indemnify

10.32 Corporate financing arrangements are becoming increasingly complex. Where companies are part of a group, their financing arrangements sometimes include intra-group guarantees of loans, one member guaranteeing loans taken out in the name of another member of the corporate group. A guarantee or indemnity of any kind by a scheme operator could increase the institution risk associated with a collective investment scheme, in particular the disruption caused to the running of the scheme should it be necessary to appoint a temporary scheme operator. The Review **recommends**, therefore, that scheme operators should be prohibited from guaranteeing or providing any indemnity in respect of loans, whether the loan is to another member of the corporate group or not.[72]

Insurance

10.33 ***Professional indemnity insurance.*** DP 53 sought comment on whether scheme operators should have to maintain professional indemnity insurance and, if so, whether its level should be prescribed.[73] If schemes had to be insured, investors would obtain some compensation in the event of loss through the negligence of the scheme operator, even if the scheme operator also lost all its assets. The issue was raised in the context of the Review's proposal not to impose a capital requirement on scheme operators. Several submissions favoured compulsory professional indemnity insurance.[74] Others did not, pointing out the high cost of such insurance and the control it might give insurance companies over who could participate in the industry.[75] Given the difficulties of prescribing a standard policy and the Review's decision to recommend a minimum capital requirement for scheme operators, the Review does not consider it necessary to require scheme operators to maintain professional indemnity insurance. The decision to take out such insurance should be a matter for each scheme operator. Some submissions suggested that whether a scheme operator has professional indemnity insurance and, if it does, the details of it, should have to be disclosed.[76] The Review considers that this matter should be left to the operation of disclosure provisions such as the Corporations Law s 1022.

72. The Review recommends in ch 6 that borrowing by a scheme operator on behalf of a scheme should be restricted to 10% of the value of the scheme's assets, unless the name of the scheme includes a word that indicates it can, or will, borrow more than 10%: para 6.10.
73. Issue 5D.
74. eg Minter Ellison Morris Fletcher *Submission* 19 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992.
75. eg Arthur Robinson & Hedderwicks *Submission* 10 December 1992; Law Council of Australia *Submission* 16 December 1992.
76. Mercantile Mutual Holdings Limited *Submission* 16 December 1992; ASCPA & ICAA *Submission* 15 February 1993.

10.34 ***Fraud insurance.*** DP 53 also asked whether fraud insurance for scheme operators is desirable. Several submissions considered it desirable but did not favour its being made compulsory.[77] Others considered the cost of such insurance and the difficulties involved in prescribing a standard level of cover to be prohibitive.[78] The Review is not convinced that it would be possible for all operators to obtain such insurance at a feasible price. Nor would it be possible to standardise the terms of all policies. The benefit of fraud insurance would vary from case to case. The Review also acknowledges the argument that insurance companies might gain de facto control over the industry as they could determine who could participate and how many new products could come onto the market and when. The Review does not recommend that fraud insurance be required for all operators. This should be a matter for individual operators.

Licensing scheme operators

The licensing system

10.35 ***Why license operators?*** Licensing is an effective way of imposing and monitoring the controls that the Review recommends for scheme operators. The Corporations Law does not expressly require managers of prescribed interest schemes to be licensed. Nevertheless, some form of licensing or approval is, effectively, required. A dealers licence is required if a person carries on a business of dealing in securities.[79] Because the ASC takes the view that issuing units in a prescribed interest scheme constitutes such dealing in securities,[80] managers of these schemes must have a dealers licence whether or not they deal in securities of other corporations. Trustees and representatives must also be approved by the ASC.[81] The Review agrees that licensing should be a feature of the regulatory framework. Licensing will enable the regulator to screen out insolvent companies, those that do not have the required level of capital and those that do not have adequate compliance measures. Licensing provides a means of monitoring the operations of schemes and imposing any necessary changes to the scheme's operation through licence conditions. It will also provide the ASC with information about the industry, which is particularly important for the purpose of surveillance. The Review **recommends** that all scheme operators should be licensed. It should be an offence for any person other than a court appointed temporary scheme operator or the administrator or liquidator for a scheme[82] to operate a collective investment scheme or to issue interests in a collective investment scheme without a licence.

10.36 ***What type of licence?*** DP 53 proposed that scheme operators should hold a special type of dealers licence. This suggestion was made because it was thought that licensing operators within the existing licensing regime for dealers would be

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77. eg AMP Society *Submission* 30 November 1992.
78. St George Funds Manager Limited *Submission* 18 December 1992; BT *Submission* 15 December 1992.
79. Corporations Law s 780.
80. See Policy Statement 16, para 8.
81. Interests in prescribed interest schemes can only be issued pursuant to an approved deed and a deed cannot be approved unless the trustee or representative appointed by the deed has been approved: Corporations Law s 1065, 1066.
82. The liquidator of a scheme can carry on the scheme but cannot issue interests in it.

more practical than establishing a separate licensing regime, especially given that many operators would be dealing in other securities quite apart from issuing units in their schemes. The Review has reconsidered this proposal. The criteria that should be relevant for licensing companies as scheme operators are different from the existing criteria for licensing dealers or investment advisers.[83] Accordingly, the Review **recommends** that there should be a scheme operators licence which is separate from dealers and advisers licences. The licence should entitle a scheme operator to deal in interests in its own scheme. It should also permit a scheme operator to advise investors about investing in the operator's scheme.[84] A scheme operator that proposes to deal in other securities in the course of managing a scheme, for example, if the scheme invests in equities, will need a dealers licence in addition to an operators licence.[85]

10.37 ***Licensing should focus on compliance.*** The main focus of the licensing process should be to reduce compliance risk.[86] It should do this in two ways. First, the primary factor that the ASC should consider when dealing with licence applications is the compliance measures the applicant proposes to implement. The ASC should be able to reject an application if it considers that the proposed compliance measures are not reasonably likely to detect in advance and prevent a possible breach of the law or the scheme constitution. Secondly, the directors of the applicant should be required to endorse the compliance measures that are to be imposed as licence conditions and certify that, in their opinion, the measures are adequate and can be implemented.

10.38 ***ASC's ability to check proposed compliance measures.*** Recently, the ASC has begun paying close attention to the systems and resources of trustee companies. It is gaining increased experience in vetting those companies before approving them as trustees for prescribed interest schemes.[87] The developing expertise of the ASC in this area will help it to assess whether proposed compliance measures meet the required standard.

10.39 ***Licence not a guarantee of compliance.*** No system of regulation, including that recommended in this report, can guarantee compliance. Licensing will not, and cannot, constitute a guarantee that the law will never be breached. The Review's proposed regime will, however, ensure that all scheme operators are made to focus on compliance and institute appropriate measures, before they commence a scheme.

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83. See para 10.43, 10.44.
84. See para 13.4.
85. In its report *Collective investments: superannuation* (ALRC 59, 1992) the Review stated that it would review the requirements for dealers licences as part of its review of collective investments. Because the Review recommends the introduction of a scheme operators licence, the issue of the standards for dealers licences has become less relevant in the context of this report and is not addressed.
86. The reasons for focusing on compliance were discussed in ch 9.
87. Until recently, it seemed that the ASC relied too much on the fact that statutory trustee companies have been approved under State or Territory legislation, which varies between jurisdictions. If the proposed trustee for a prescribed interest scheme is a trustee company, the ASC does not consider the company's resources and ability in respect of that particular scheme nor does it give consideration to the impact of other schemes in respect of which the applicant is acting as an approved trustee or representative on its capacity to handle additional work: NCSC Release 126 para 4. It does consider these factors if the proposed trustee is not a statutory trustee company.

10.40 *Not necessarily a defence to proceedings.* If a court determines that an operator was taking all reasonable measures to prevent relevant contraventions of the law and the scheme constitution, the operator should have a defence to some criminal and civil penalty proceedings in some circumstances.[88] The fact that the operator is complying with the conditions of its licence which relate to compliance will not necessarily establish the defence. It may be considered by the court but the determination whether the measures the defendant took were reasonable is for the court.

The licensing process — assessing compliance measures the main consideration

10.41 *Register of operators.* Under the Corporations Law, the ASC must keep a register of the holders of securities dealers licences and investment advisers licences.[89] The Review **recommends** that the ASC should keep a register of licensed operators of collective investment schemes. The information to be kept on the register should include the name and ACN of the operator, a copy of the operator's licence and any conditions imposed by the ASC noted on it, the name and registration number of each scheme that the company operates and the names of the directors of the scheme operator. The register should be made available for any person to inspect and to copy.

10.42 *Application for a scheme operators licence.* An application for a scheme operators licence should be made to the ASC in writing and in accordance with a form approved by the ASC. The application should include, among other things

- the applicant's name and ACN
- a copy of the scheme's constitution
- in respect of each director of the applicant, a statement signed by the director setting out whether he or she has been associated with the applicant or an associate of the applicant in the previous three years and whether he or she has a shareholding in the applicant or an associate of the applicant
- the name and registration number of other schemes (if any) that the applicant operates
- a summary of the proposed compliance measures.

The ASC should be able to ask for further information.

10.43 *ASC to consider compliance measures.* An applicant should not have a right to a scheme operators licence. The Review **recommends** that the ASC should be required to consider whether the compliance measures summarised in the application are reasonably likely to detect in advance and prevent contraventions of the law or of the scheme's constitution. If the ASC considers that the measures disclosed in the summary or otherwise known to it are not likely to do so, it should be able either to refuse to grant a licence, stating its reasons, or to grant a licence subject to conditions to observe specified compliance measures.[90]

88. The draft legislation in Volume 2 of this report indicates in respect of each offence whether the defence applies.
89. s 789.
90. For conditions that may be imposed, see para 10.46.

10.44 ***Factors to be taken into account.*** While there is a need for flexibility in compliance measures, there are certain fundamental matters concerning the way an applicant proposes to operate a scheme that the regulator should always examine when considering proposed measures. These matters should be specified in the Corporations Law both to guide the ASC and to help applicants prepare their licence applications. The Review **recommends** that the law should set out a non-exhaustive list of compliance factors that the ASC must take into account in considering licence applications. They include

- arrangements for holding the scheme property, including procedures to ensure the separate identification of scheme assets
- measures for separating decision making relating to the investment and expenditure of scheme property from the implementation of those decisions
- arrangements for auditing the scheme, including the frequency of audits by internal and external auditors
- arrangements for keeping the records of the scheme.

In addition the ASC should take into account any report commissioned by the applicant (and submitted to the ASC) as to the adequacy of the compliance measures proposed and any matter which the ASC considers relevant to the evaluation of those compliance measures. The Review envisages that, in due course, the ASC will develop more detailed guidelines to assist applicants in determining what compliance measures are adequate for particular kinds of schemes. The ASC should, nevertheless, still have to consider in each case the adequacy of the proposed compliance measures for the particular scheme.

10.45 *Custody arrangements a factor in assessing compliance risk.* The arrangements under which a scheme's assets are held, whether by the scheme operator or by an external custodian, will be relevant to the compliance risk of a scheme.[91] Accordingly, these arrangements should be examined closely by the ASC. It should be left to the ASC to determine whether the compliance measures for a scheme in which the operator holds the legal title will be reasonably likely to detect in advance and prevent possible non-compliance.[92] Likewise, if a scheme operator chooses to place the scheme property with another person, the ASC will have to consider the proposed compliance measures in light of that arrangement. The ASC will need to consider the capacity of the proposed external custodian to perform its role, as specified in the agreement between it and the scheme operator. The Review **recommends** that, in considering whether proposed compliance measures are reasonably likely to detect in advance and prevent a potential breach of the law, the ASC should take into account who will have the legal title to the scheme's assets and, if an external custodian is to have legal title, the arrangements between the proposed custodian and the operator.

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91. See also discussion at para 9.15, 9.16.
92. Any custody arrangement will set out the circumstances in which the custodian will release the assets, eg, on instructions from a particular officer of the scheme operator, on instructions plus proof that the transaction is completed etc. There seems no reason why the same level of protection against fraud cannot be achieved if similar procedures were set up within a scheme operator.

10.46 ***Conditions on licences.*** There should be specified grounds on which the ASC must refuse to grant a licence.[93] Unless the applicant is refused a licence on one of those grounds, or the ASC considers that the applicant's compliance measures are not reasonably likely to detect in advance and prevent contraventions, the ASC must notify the applicant that it will issue a licence subject to the conditions contained in the notice. The conditions must relate to compliance. They may be the measures summarised in the application, additional or substitute measures, conditions limiting or restricting the activities of the scheme to activities for which the compliance measures summarised by the applicant are appropriate or any combination of these.

10.47 ***Directors of operator to endorse conditions.*** The notice setting out the conditions that the ASC proposes to impose on the applicant's licence must be examined by the applicant's directors with a view to determining whether, in their opinion

- the conditions are reasonably likely to detect in advance and prevent possible breaches of the law and the scheme constitution and
- the operator is capable of complying with them.

The Review anticipates that in some cases there may be a process of negotiation between the ASC and the applicant about the proposed conditions. The Review **recommends** that the directors of the operator should, before the ASC grants the licence, certify that they have examined the conditions proposed by the ASC and that they are satisfied that they are reasonably likely to detect in advance and prevent possible breaches of the law and the scheme constitution and can be put into effect by the applicant if the application is granted. This will impress on directors the importance of the conditions of the licence and will commit the operator to the compliance measures suggested by the ASC. This approach will achieve a focus on addressing compliance risk without introducing inflexibility into the regime. It may also reduce the risk that an operators licence will be seen as some sort of guarantee by the ASC that the operator will comply with the law. If the directors are not prepared to sign off on the conditions suggested by the ASC, and the ASC is not prepared to amend the conditions, the applicant should be able to seek review of the ASC's decision by the Administrative Appeals Tribunal.

Operator to comply with licence conditions

10.48 A scheme operator must comply with the conditions imposed on its licence. Failure to do so should be a contravention of the Law but should not be an offence. An operator should have to advise the ASC immediately it breaches a licence condition. Failure to advise the Commission will be an offence.[94] A breach of a condition will trigger the ASC's investigative powers and may lead to the ASC revoking the operator's licence. The operator will have to show to the ASC that what it was doing by way of compliance measures was at least as good as the licence conditions. This will force operators to give effect to compliance measures at

93. These are dealt with at para 10.52-10.55.
94. Corporations Law s 787.

least as effective and thorough as those imposed by the ASC and which their directors have themselves certified as adequate to reduce compliance risk.

Changing compliance measures

10.49 A scheme operator may, at its own initiative, employ additional compliance measures in respect of one or more of its schemes.[95] If it otherwise wishes to alter its compliance measures as specified as a condition of the licence, it must seek approval from the ASC. Unless the ASC considers that the proposed measures are not reasonably likely to detect in advance and prevent a possible breach of the law, it may substitute those measures by imposing different conditions on the operators licence. The ASC may itself initiate changes to the conditions of the operator's licence at any time.

Operator's qualifications and experience

10.50 Before granting a securities dealers or investment advisers licence, the ASC must be satisfied that the applicant's educational qualifications and experience are adequate having regard to the nature of the duties of a holder of a licence of the kind applied for.[96] The Review has considered whether a similar test should be applied to the officers of the applicant for a scheme operators licence. There was some support in consultations for requiring the ASC to exclude individuals that the ASC considers to be incompetent. The Review does not consider it appropriate to make the ASC the arbiter of a person's competence, based on education and experience, to operate collective investment schemes. The market should perform that role, as it does in the corporate sphere. Consideration of these factors may impinge, however, on the judgment of the ability of identified individuals to implement and maintain the proposed compliance measures. The law should not require the regulator to be otherwise satisfied that the qualifications and experience of the officers of an applicant for a scheme operators licence meet any particular standards.[97]

Keeping out dishonest or insolvent participants

10.51 ***Reducing compliance risk.*** Chapter 9 noted that the participation in the collective investments industry of corporations and individuals with a history of dishonest behaviour is likely to increase the compliance risk faced by investors. The licensing process should be used to screen such people before they are allowed into the industry.

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95. It may wish to do so, for example, to improve its systems and to increase the likelihood of being able to prove a defence if it should be prosecuted for a breach of the law.
96. s 783(2)(c). In the case of a corporate applicant, the ASC must be satisfied that each responsible officer of the applicant has educational qualifications and experience that are adequate 'having regard to the duties that the officer would perform in connection with the holding of the licence': Corporations Law s 784(2)(c). 'Responsible officer' is defined in the Corporations Law s 9 to be an officer of a body corporate who would perform duties in connection with the holding of the licence.
97. The qualifications and experience required in respect of dealing in or advising on interests in collective investment schemes are discussed in ch 13.

10.52 ***External administration.*** A company that is externally administered should not be permitted to operate a collective investment scheme.[98] The solvency of the officers of a company is also relevant to compliance risk. No insolvent under administration may be an officer of a corporation.[99] The Review **recommends** that the Corporations Law should provide that the ASC must reject an application for a scheme operators licence if the applicant is externally administered or one of its officers is an insolvent under administration.

10.53 ***Conviction for serious fraud.*** Individuals with a current record of dishonesty should not be allowed to participate in the operation of collective investment schemes. DP 53 proposed that, because of the high standards expected of the operators of collective investment schemes, a conviction for serious fraud[100] should automatically exclude a person from operating a collective investment scheme.[101] It also proposed to exclude a company if any of its responsible officers have been convicted of serious fraud.[102] These proposals received wide support.[103] The Review remains of the view that it is inappropriate for an individual convicted of a serious fraud to be an officer of a scheme operator. It notes that, under the Corporations Law, a person who has been convicted of serious fraud is prohibited from managing a corporation for five years after the conviction or, if the person was sentenced to imprisonment, after release from prison.[104] The Review **recommends** that the Corporations Law should provide that the ASC must refuse to grant a scheme operators licence if any officer of the applicant has been convicted of serious fraud in the past five years, has not been released from prison for more than five years after serving a sentence for a conviction for serious fraud or is otherwise prohibited from managing a corporation. A company that has such an officer and that wishes to operate a scheme will have to remove the convicted person from any executive position. The Review no longer considers, however, that a company that has been convicted of serious fraud should be automatically precluded from operating a scheme. The conviction may be a very old one. The company may well have dismissed the officer or officers whose actions led to the company's conviction

98. 'Externally-administered body corporate' is defined in the Corporations Law s 9 and includes a body corporate that is being wound up or in respect of property of which a receiver has been appointed. In many instances, such a company would, in any case, be unlikely to be able to fulfil the recommended capital requirement: see para 10.31.
99. Corporations Law s 229(1).
100. As defined in the Corporations Law s 9: an offence involving fraud or dishonesty, being an offence against an Australian law or any other law and punishable by imprisonment for life or for a period, or maximum period, of at least 3 months.
101. Subject to the spent convictions provisions of the *Crimes Act 1914* (Cth): proposal 5.2. In most cases, a conviction is spent after 10 years have passed since the date of conviction, provided the person was not sentenced to imprisonment or was sentenced to imprisonment for the offence for no more than two and a half years. If the person was dealt with as a minor the conviction is spent after five years: *Crimes Act 1914* (Cth) s 85ZM. This proposal applied to both corporate and individual applicants because DP 53 did not propose that operators be required to be corporations.
102. Subject to the spent convictions provisions of the *Crimes Act 1914* (Cth): proposal 5.2. 'Responsible officer' is defined in the Corporations Law s 9 to be an officer of a body corporate who would perform duties in connection with the holding of the licence.
103. eg T Valentine *Submission* 5 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992; ISC *Submission* 12 November 1992; St George Funds Manager Limited *Submission* 18 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
104. s 229.

and taken other steps to ensure that fraud does not recur. It **recommends**, nevertheless, that an applicant for a scheme operators licence should be obliged to disclose to the ASC in its application any conviction for serious fraud and the circumstances in which it arose. The ASC must take into account that fact and whether the applicant has taken steps reasonably likely to prevent a similar fraud being committed again.

10.54 *Civil penalty for act of dishonesty.* DP 53 proposed that a corporation that has been subject to a civil penalty imposed for an act of dishonesty, or one of whose responsible officers has been subject to such a civil penalty, should not be permitted to operate a collective investment scheme.[105] This proposal was supported in submissions.[106] The Review still considers it appropriate to prevent dishonest individuals from being involved in the operation of collective investment schemes. The Review **recommends** that the Corporations Law should provide that the ASC must refuse to grant a scheme operators licence if any officer of the applicant has been subject to a civil penalty for an act of dishonesty in the five years before the application is made or is otherwise prohibited from managing a company.[107] The Review now considers that, as with convictions for serious fraud, a company that has been made subject to a civil penalty for an act of dishonesty should not be automatically disqualified from operating a collective investment scheme. Whether the company should be refused a licence should depend instead on what steps it has taken to ensure that such a breach does not occur again. The Review **recommends** that, if the applicant has been subjected to a civil penalty for an act of dishonesty, this fact should be disclosed to the ASC. The ASC should consider it in assessing the application. Particular consideration should be given to how long ago the penalty was imposed, whether the officer whose actions led to the penalty being imposed is still an officer of the company and whether the company has taken steps which are reasonably likely to prevent a similar act of dishonesty taking place again. If the ASC is satisfied that those steps have been taken, the applicant should not be refused a licence merely because of the penalty.

No licence if fewer than half directors are non-executive

10.55 Chapter 9 noted the Review's view that non-executive directors are able to play a role in reducing compliance risk. The Review **recommends** that the ASC should refuse to grant a scheme operators licence to an applicant unless at least half of its directors are non-executive. Scheme operators will have to provide details about their directors when applying for an operators licence. The details will include whether the directors are associated with the operator or an associate of the

105. Proposal 5.3.

106. eg JP McAuley *Submission* 23 November 1992; ASCPA & ICAA *Submission* 15 February 1993; Mercantile Mutual Holdings Limited *Submission* 16 December 1992; FPAA *Submission* 7 December 1992.

107. A civil penalty will include a penalty imposed under the Corporations Law Pt 9.4B for breach of a civil penalty provision. An example of other civil penalties includes civil penalties imposed under the *Trade Practices Act 1974* (Cth). Pt 9.4B provides for the court to make an order prohibiting a person from managing a corporation for a period specified in the order: s 1317EA(3)(a). Managing a corporation is defined, for the purposes of specified sections, in s 91A.

operator and whether they have any shareholding in the operator or its associates. From this information, the ASC will be able to assess whether the requirement that at least half the directors of an operator be non-executive is satisfied.[108]

Updating a scheme operators licence

10.56 A scheme operator must apply to the ASC to have any additional scheme registered and the registration number endorsed on its licence. Before doing so, the ASC must consider whether the compliance measures that the operator proposes for the new scheme, whether they are new or are the same measures that the operator has for its existing schemes, are likely to detect in advance and prevent a potential breach of the law or of the additional scheme's constitution. The ASC must consider whether there will be any reduction in the capacity to detect and prevent a breach of the law or the constitution of the schemes currently endorsed on the licence. The agreed upon compliance measures must be made conditions of the operator's licence.

Voluntary retirement of scheme operator

10.57 A scheme operator may wish to retire as the operator of one or more of its collective investment schemes. It is important that schemes not be left without an operator. An operator should not be allowed to retire unless it has arranged for a replacement operator.[109] It could ask investors to approve a replacement operator. Unless and until this occurred, it would have to remain as the operator or obtain court appointment of a temporary operator. The Review **recommends** that the Corporations Law should provide that a company may not retire as operator of a collective investment scheme until a replacement operator has been appointed.

108. Failure to maintain the required proportion of non-executive directors should be grounds for revocation of a scheme operators licence: see para 14.30. It should also be an offence: see para 9.10.

109. A proposal in DP 53 to this effect (Proposal 5.11) received wide support. See, eg, FPAA *Submission* 7 December 1992; ISC *Submission* 12 November 1992; MLC Investments Limited *Submission* 18 December 1992.

11. The investor

Introduction

11.1 The rights and obligations of the parties to a collective investment scheme must be clearly defined. The Review sets out in chapter 10 the role and duties of scheme operators. This chapter deals with the rights of investors. The Review considers that investors choose collective investment schemes because they prefer not to participate in the day to day management of their investments.[1] The primary right of investors, therefore, will be to information about the scheme. The chapter deals with this first. Investors should only have a more active role where fundamental aspects of the nature or structure of the scheme are concerned. The chapter discusses these situations and makes recommendations about meetings, voting and takeovers. It also proposes dispute resolution procedures. Finally, it recommends that investors' rights be enforceable through the courts.

Investors' rights to information

Introduction

11.2 Investors' access to information will be enhanced by the Review's recommendation in chapter 5 for improved disclosure standards for collective investment schemes, particularly in relation to annual and half yearly reports.[2] This section deals with the right of access to certain documents and the right to be told about certain events or developments in the management of the scheme.

Access to documents

11.3 ***Registers and material contracts.*** Currently investors in prescribed interest schemes have rights under the Corporations Law to inspect, free of charge, at the registered office of the management company

- the register of interest holders[3]
- the material contracts referred to in the prospectus of the scheme.[4]

NCSC policy modified the right of access to the register to allow a manager to deny access if the information is to be used other than for specified purposes.[5] The Review **recommends** that the requirement to maintain a register of investors should continue. The register should indicate the extent of each investor's holding.

1. See para 3.3.
2. See para 5.27, 5.31, 5.35.
3. Corporations Law s 1070; Corporations Regulations reg 7.12.15(6)(a).
4. Corporations Law s 1029.
5. eg to call a meeting of investors: NCSC Release 138. The ASC is reviewing this policy statement: ASC Media Release 93/34.

The Review also **recommends** that investors in collective investment schemes should have access to material contracts referred to in a scheme prospectus. The ASC should, however, have power to permit a scheme operator to deny access where appropriate.

11.4 ***Other books.*** The Corporations Law s 319 permits a shareholder in a company to apply to the court for an order to inspect the company's books. Access may be granted if the court is satisfied that the member is acting in good faith and for a proper purpose. If an order is granted, only a legal practitioner or auditor may inspect the books on the shareholder's behalf. The Review **recommends** that investors in a collective investment scheme should have a similar statutory right of access to the books of the scheme.

Issue of certificate

11.5 Investors need to know when they have been allotted interests in a scheme. They also need evidence of that fact. Accordingly, the Review **recommends** that scheme operators should be required to issue certificates to purchasers of interests within two months after the allotment of those interests unless the constitution otherwise provides.[6]

Change in investment policy of scheme

11.6 ***Current law.*** Investors in a prescribed interest scheme must be informed about any change in investment policy that they would not have expected, having regard to the information contained in prospectuses issued in relation to the scheme. A change in investment policy cannot be implemented without giving investors adequate time to dispose of their interests.[7]

11.7 ***Proposal and submissions.*** DP 53 questioned the effectiveness of the law's reliance on disclosure of information in prospectuses.[8] The law does not cater for closed schemes for which there is no prospectus on issue. Nor does it assist those who invested in a scheme before the issue of a prospectus that contains information that relieves the manager of the obligation to give a separate notice of a proposed change in investment policy. It also encourages companies to make their prospectuses very general and all-encompassing. The Review proposed, therefore, that investors in collective investment schemes should

- be notified in writing of any change in the investment policy set out in the scheme's most recent annual report or half yearly report
- be allowed a reasonable period to dispose of their interest in the scheme before the change is implemented.

Submissions identified various problems with the Review's proposal. Several pointed out that requiring a reasonable period after notice to investors before implementing a change in investment policy could prevent scheme operators from

6. cf Corporations Regulations reg 7.12.15(2)(a).
7. Corporations Regulations reg 7.12.15(6)(e).
8. DP 53 para 7.12.

responding swiftly to changing market trends, possibly to the detriment of investors.[9] Other submissions argued that it would be difficult to define a 'change in investment policy': would it be a change between classes of assets (for example, from real property to shares), a change in weighting of particular classes in the investment portfolio or a change within a class of assets (for example, from industrial to resource shares)?[10] One submission suggested that only material changes should have to be notified.[11]

11.8 *No recommendation.* The Review accepts that requiring prior notification to investors before implementing a change of policy would be unduly restrictive. The Review elsewhere recommends that significant changes to a scheme's state of affairs should be included in the annual and half yearly reports.[12] This information would also constitute a notifiable event under continuous disclosure.[13] The Review considers that this would include material changes in investment policy.

Change of controlling interest in scheme operator

11.9 DP 53 proposed that investors should not have any right to be notified of a change in the controlling interest in a scheme operator.[14] One submission argued that investors should be notified of such a change to enable them to sell their interests if they are not satisfied with the new controllers.[15] Notification of a change in controlling interest would be consistent with full disclosure of relevant information to investors. However, it is not always easy to determine what constitutes a controlling interest.[16] The most important usual consequence of a change in control of a company is a change in composition of the board of directors. Notifying investors of all such changes may be the best way of indicating to them that a change in controlling interest in the operator may have occurred. The Review acknowledges that a requirement to report changes within a short time after they occur would involve undue expense to the scheme. It therefore **recommends** that the half yearly and annual reports of a collective investment scheme should include details of changes of directors of the scheme operator. This would be additional to the existing requirements to lodge details of changes of directors with the ASC.[17]

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9. Macquarie Investment Management Limited *Submission* 24 November 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992.
10. eg T Valentine *Submission* 5 November 1992; M Starr *Submission* 12 November 1992.
11. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992.
12. See para 5.27, 5.31.
13. See para 5.34.
14. Proposal 7.9
15. T Valentine *Submission* 5 November 1992.
16. Control under the Corporations Law is taken to be an 'entitlement' to 20% of the shares in a company. The definitions of 'entitlement' and the other concepts involved in 'entitlement' are technical and complex. In some cases they may not give an accurate view of a person's ability to control a company.
17. Corporations Law s 242, 242A.

Disclosure of substantial investors

11.10 ***CSLRC recommendation.*** In its report on prescribed interests, the Companies and Securities Law Review Committee (CSLRC) recommended that any person who intends to acquire an interest from an existing investor 'in circumstances where the acquisition could institute or increase the entitlement to interests of any company that would be eligible to be the manager of the scheme' should provide written notice to the trustee at least 14 days before the acquisition. The trustee of the scheme should then

- use reasonable efforts to find out whether the acquirer intends to bid to supplant the existing manager
- inform interest holders.[18]

One purpose of this notification would be to help investors decide whether to remain in the scheme. The CSLRC recommendations were in lieu of any other requirement for notification of interests or any extension to prescribed interest schemes of the rules governing takeovers.

11.11 ***Proposal and submissions.*** The Review considered the CSLRC recommendation cumbersome and its disclosure threshold uncertain. Instead, DP 53 proposed that

- the principles in the Corporations Law Pt 6.7 concerning substantial shareholdings should apply to all listed or 'large' collective investment schemes (meaning, for instance, schemes with more than 100 investors, or such other number as may be prescribed)
- investors having a 'major stake' in a collective investment scheme should be required to notify their interests (a 'major stake' should be an 'entitlement'[19] to 10% of the value of issued interests[20])
- those investors should also be required to notify changes of more than 5% in their entitlements
- the operator should be required to keep a register of substantial investors
- for listed collective investment schemes, copies of notices should also be served on the ASX.[21]

Several submissions considered it impractical to require disclosure of percentage investments. The principal objection was that, as the number of issued interests may change daily, it would be too onerous to require investors to constantly

18. CSLRC Report *Prescribed Interests* Sydney, 1988, para 124.
19. Entitlement is defined in the Corporations Law s 609. In broad terms, this would cover interests in a collective investment scheme in respect of which the investor and the investor's associates have the power to vote and dispose.
20. The Review considered that a 5% disclosure threshold and a 1% change of entitlement notification requirement, as required under Part 6.7, may be too burdensome (particularly for investors with relatively small holdings) as the number of interests may change constantly.
21. DP 53 para 7.19 and proposal 7.10.

recalculate their percentage investment.[22] Another objection was that passive investors may require professional advice on the intricacies of the concept of 'entitlement'.[23]

11.12 ***Recommendation.*** The Review supports the principle that the identity of substantial investors close to absolute control should be disclosed. This information may be useful to other investors in deciding whether to join, remain in or leave a scheme. The Review notes that the substantial shareholding provisions apply only to listed public companies. The Review sees merit in applying a substantial investor notification requirement to both listed and unlisted collective investment schemes. However, the system of disclosure of substantial shareholdings in the Corporations Law Pt 6.7 would need to be modified for collective investment schemes given the frequent fluctuations in the number of issued interests in some schemes.[24] This issue should be part of the general review of the application of the takeover provisions to collective investment schemes recommended by the Review.[25]The Review **recommends** that, in the interim, operators of listed collective investment schemes should have to keep a register of substantial interest holdings. The Review **recommends** that the operator of a listed collective investment scheme should include in the annual report of the scheme the total number of voting interests in the scheme as at the date of the report.[26] An investor should have to notify the operator within 14 days after receiving the annual report if, on the basis of the information in the report,

- it is entitled to 30% of the voting interests in the scheme (that is, if it and its associates have power to vote in respect of, or dispose of, 30% of the interests in the scheme)
- its voting entitlement has changed by at least 5% since it last notified the operator of its substantial holding or
- it is no longer entitled to 30% of the voting interests.

Any notification should indicate the investor's current entitlement. The scheme operator should record on the register of substantial holdings the current entitlement of a substantial investor. The register should be open to inspection by investors without charge and to any other person upon payment of an amount up

22. MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; ANZ Funds Management *Submission* 21 December 1992.
23. M Starr *Submission* 12 November 1992.
24. Such as cash management trusts. Fluctuations in the number of shares that result from share buy-backs are dealt with in the Corporations Law s 206UB which applies to listed companies. That provision requires a company to send holders of shares in a particular class a notice of the number of issued shares in that class after the implementation of a buy-back scheme. This enables shareholders to work out their new shareholding entitlement for the purpose of giving substantial shareholding notices. A similar system for collective investment schemes would be extremely costly and would impose considerable administrative burdens given the frequent changes in the number of interests on issue compared with the much lower frequency of share buy backs.
25. See para 11.30.
26. Any interests held by the scheme operator or its associates should be deemed to be non-voting interests for the period during which they are held by the operator, except where they are held as a bare trustee and the operator or the associate does not have any discretion in determining how to vote: see para 11.26.

to a prescribed maximum.[27] This register will enable investors to determine whether the votes that a particular investor and its associates control are approaching the 50% level required to replace the scheme operator or terminate the scheme. The Review recognises that under this recommendation a register of substantial holdings may only be accurate for a brief period after the release of the annual report. Nevertheless, it considers that a yearly 'snapshot' will give investors some information about the pattern of major holdings in the scheme. Substantial investors should be able, but not obliged, to notify the operator of a change in its entitlement at any other time. The operator should enter such information on the register. The Review **recommends** that the operator of a listed collective investment scheme should have to include on a separate part of the register details of its entitlement to interests if this exceeds 30% of the total issued interests. The operator should have to amend the register within 2 business days if its entitlement has changed by 5% from the figure in the register or its entitlement falls below 30% of total issued interests.

Investors' powers

Introduction

11.13 DP 53 sought comment on what powers investors should have. This issue principally relates to the circumstances in which a scheme operator may or must call a meeting of investors (other than upon a lawful requisition by investors) to obtain their approval to a particular course of action.[28] The Review has concluded that investors should have power to approve

- the merger of the scheme with another scheme[29]
- the appointment of a replacement scheme operator where a temporary scheme operator appointed by the court recommends that the scheme continue[30]
- any action which will financially benefit a related person or entity.[31]

Investors should also have powers

- to remove the scheme operator[32]
- to terminate a collective investment scheme[33]
- to propose and approve amendments to the scheme's constitution.[34]

27. cf Corporations Law s 715.
28. DP 53 issue 7B.
29. See para 11.14.
30. See para 11.16. The appointment of temporary scheme operators is discussed at para 14 20.
31. See para 10.25.
32. See para 11.17.
33. See para 8.5, 8.6.
34. See para 11.21, 11.22.

Mergers

11.14 The proliferation of collective investment schemes following the deregulation of the finance sector in the 1980s may well continue. It is equally likely, however, that many schemes will consider merging for financial reasons or to achieve economies of scale. The merger procedure is usually a matter for each scheme's constitution. DP 53 proposed that

- mergers should require the consent of a majority of the investors of each scheme who vote on the proposal
- the notice of meeting should include an independent expert's report containing all relevant information on the proposed merger, the reasonable costs of which should be borne by the scheme.[35]

The discussion paper also raised the possibility of adapting the Corporations Law Pt 5.1 for collective investment schemes.[36] Pt 5.1 allows companies to enter into schemes of arrangement and provides for the amalgamation of companies. It authorises the court to make orders transferring assets from one company to another. Submissions generally favoured legislative provisions which would facilitate the merger of schemes.[37] However, there was no clear preference on the best way to achieve this. The Review considers it unnecessary to have both a merger procedure such as that proposed in DP 53 and a provision based on Pt 5.1. It **recommends** that, in the interests of consistency, the mergers provisions for collective investment schemes should be based on the Corporations Law Pt 5.1 as it applies to amalgamation of companies. These provisions should not deal with compulsory acquisition of minorities.[38] This matter should be considered in the context of compulsory acquisitions in takeovers of schemes.[39]

Power to approve transfer of the right to operate a scheme

11.15 A decision by a scheme operator to sell or otherwise dispose of its right to manage a scheme may have significant consequences for investors, particularly where they have been attracted to a particular scheme by the reputation of the operator. DP 53 considered, however, that to permit a change of operator only with the consent of the investors would be unworkable.[40] It proposed instead that the scheme operator should give investors advance written notice of its intention to transfer the right to manage the scheme and investors should have a reasonable

35. Proposal 7.11.
36. Issue 7F. The CSLRC Report para 129-130 recommended the enactment of such provisions to permit the amalgamation and other reconstruction of trusts. ASC Policy Statement 16 (para 20(c), 22, 32, 48A) sets out the circumstances in which the ASC will agree to the restructuring of an unlisted property trust to a redeemable listed property trust, a fully listed property trust or a fixed term property trust.
37. eg Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; IFA *Submission* 1 December 1992; National Mutual *Submission* 3 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
38. Corporations Law s 414.
39. The Review recommends that there should be a separate review of takeovers of collective investment schemes: see para 11.30.
40. DP 53 para 7.16.

time to redeem their interest in the scheme before the transfer.[41] Submissions supported the requirement for notification,[42] but objections were raised to providing investors with any period to dispose of their interest before the transfer. One submission said that the latter requirement would be unworkable unless the scheme were relatively liquid, the number of investors objecting was small and the redemption of their interests did not have a significant impact on the investors who elected to continue.[43] The Review has considered this issue further in the light of other recommendations permitting the appointment of a temporary scheme operator. It **recommends** that an operator should not be able to transfer its right to operate a scheme without the approval of investors unless pursuant to the court appointment of a temporary scheme operator.[44]

Power to appoint a successor to temporary scheme operator

11.16 A temporary scheme operator may recommend to the court that a scheme continue or that it be terminated.[45] The Review **recommends** that where a temporary scheme operator recommends that the scheme should continue and the court agrees, the temporary scheme operator should be obliged to, and the investors may, call a meeting of investors to appoint a replacement scheme operator. A simple majority by value of investors who vote may appoint the replacement. A company may not be proposed as a replacement scheme operator unless the ASC has certified that it is prepared to licence the company as the scheme operator if the investors appoint it to be the operator.

Power to remove the scheme operator

11.17 The ultimate expression of dissatisfaction by investors in a collective investment scheme is to remove the scheme operator. Currently the trustee or manager of a prescribed interest scheme must cease to act if the holders of the value of 50% or more of the prescribed interests resolve at a meeting that the trustee or manager should be removed.[46] DP 53 proposed that this right be retained.[47] Submissions overwhelmingly supported the Review's proposal.[48] The Review **recommends** that investors in a collective investment scheme should be

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41. Proposal 7.8.
42. eg T Valentine *Submission* 5 November 1992; JP McAuley *Submission* 23 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992; MLC Investments Limited *Submission* 17 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; Australian Film Commission *Submission* 7 January 1993.
43. Law Council of Australia *Submission* 16 December 1992.
44. See para 14.20.
45. For the appointment of temporary scheme operators, see 14.20. For winding up of a scheme see para 8.11.
46. Corporations Regulations reg 7.12.15(8)(d) (trustee), 7.12.15(10)(g) (management company). No procedure is laid down for substituting a trustee, nor are any rights of review or appeal specifically prescribed.
47. Proposal 7.12.
48. eg JP McAuley *Submission* 23 November 1992; IFA *Submission* 1 December 1992; MLC Investments Limited *Submission* 17 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992.

able to remove the operator by the approval of the holders of more than 50% of the value of the voting interests in the scheme.[49] If the investors agree to remove the scheme operator but cannot agree on a replacement operator, the current operator should be obliged to apply to the court for a temporary scheme operator. An investor or the ASC may apply for appointment of a temporary scheme operator if the removed operator does not act.

No power to give directions to operator

11.18 *Generally.* Investors in prescribed interest schemes may call a meeting to give directions to the management company or trustee.[50] The manager or trustee is bound to comply with a direction unless it is inconsistent with the deed or the Corporations Law, though neither is liable for anything done pursuant to a direction.[51] DP 53 proposed that the power of investors to give directions be restricted to matters concerning the accounts of the scheme and of the operator.[52] It sought comment on whether investors should have a power to direct the operator on this or any other matter.[53] Several submissions took particular exception to the suggestion that investors should have a power to give directions in relation to accounts of the operator.[54] The Review considers that to give investors a power to direct the scheme operator as to the management of the scheme would be inconsistent with the principle that the operator (rather than the investors) is responsible for the management of the scheme. It is also arguable that an operator acting pursuant to a direction given by investors may be the agent of the investors who, in consequence, assume personal liability. The Review therefore **recommends** that scheme investors should have no power to give directions to the operator.

11.19 *Directions on how to vote shares.* Currently, the management company or trustee of a prescribed interest scheme must obtain the approval of investors before exercising any voting right to elect directors of a company, the shares in which are property of the scheme.[55] This obligation is intended to prevent management companies and trustees from exercising these voting rights to promote their own interests. The Review does not consider that a similar requirement should be imposed on a scheme operator. The scheme operator will be under an obligation not to exercise its powers or perform its duties in the interest of itself or anyone else if that interest is not identical to the interests of scheme investors generally.[56] This will provide adequate protection against abuse in the exercise of these voting rights.

49. The rules in relation to voting on a resolution are discussed at para 11.26, 11.27.
50. Corporations Law s 1069(1)(m).
51. Corporations Law s 1069(13).
52. Proposal 7.5.
53. Issue 7C.
54. Macquarie Investment Management Limited *Submission* 24 November 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; MLC Life Limited *Submission* 18 December 1992.
55. Corporations Law s 1069(1)(k).
56. See para 10.8

Authorising amendments to the scheme's constitution

11.20 ***Proposal and submissions.*** Any proposal to amend a prescribed interest deed requires the approval of investors, except where the trustee reasonably believes that the modification will not adversely affect their rights.[57] The requirements for approval are that

- the holders who vote at the meeting (whether in person or by proxy) hold at least 25% of the value of prescribed interests held by persons entitled to vote
- at least 75% of those holders vote (whether in person or by proxy) in favour of the modification.[58]

DP 53 supported the same voting requirements for collective investment schemes. One submission argued, however, that the requirement for 75% approval is unrealistically high and would effectively prevent amendment of a scheme's constitution.[59] The Review does not agree. It considers that significant changes in the governing instrument of a scheme in which investors have placed their money should only be made where there is strong investor support.[60] Several submissions opposed allowing any amendments without investor approval.[61] The Review considers that there should be a simple way for minor amendments which do not adversely affect the interests of investors to be made without their approval. This would avoid the expense and delay of a meeting.

11.21 ***Recommendation — amendment proposed by the operator.*** The Review **recommends** that, where the operator proposes any amendment to a scheme's constitution, it should give investors and the ASC notice of the proposed amendment and inform them of

- details of the amendment sought
- the reasons for the proposed amendment.[62]

If the operator seeks the approval of investors for the amendment, it should call a meeting giving 21 days notice. An amendment may be approved by a vote of 75% or more of at least 25% of the value of interests in the scheme held by persons entitled to vote.[63] Where the operator considers that a proposed amendment is minor and not adverse to investors' interests, it may choose instead merely to notify the ASC and investors. The ASC and investors should have 28 days after receiving notification of the proposed amendment to require the scheme operator to

57. Corporations Law s 1069A. Most trust deeds also permit a trustee to consent to amendments made as a consequence of amendment to the law or amendments of a technical or administrative nature without reference to the general body of investors.
58. Corporations Law s 1069A(2)(c), (d).
59. County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
60. The 75/25 formula permits changes to the scheme's constitution with the approval of as little as 18.75% of the value of the interests in the scheme.
61. eg H Baker *Submission* 26 November 1992.
62. Corporations Regulations reg 7.12.15(1)(g) sets out the current requirements for investors to be given notice of and information about matters to be considered at meetings.
63. The rules in relation to voting on a resolution are discussed at para 11.26, 11.27.

call a meeting of investors to consider and vote on the amendment.[64] If the ASC and investors do not require a meeting, the scheme operator may make the amendment at the expiration of the 28 day period. The non-executive directors of the scheme operator will have an important role in protecting the interests of investors by ensuring that proposed amendments to a scheme's constitution that are not minor and may be adverse to investors' interests are referred to the investors for approval.

11.22 ***Recommendation — amendment proposed by investors.*** Investors should have the right to propose amendments to the scheme's constitution and to requisition a meeting to consider them. Voting requirements for approval of amendments proposed by investors should be the same as for amendments proposed by the operator. The Review **recommends** that, in addition, a proposal put forward by investors should require the approval of the operator. The Review considers that an operator should not be required to administer provisions with which it does not agree and which were not part of the original constitution. Failure to consent may, however, be evidence of oppression.

Power to call meetings

11.23 The manager of a prescribed interest scheme must call a meeting on application by a specified number of investors.[65] DP 53 proposed that investors in collective investment schemes should have a similar requisition power.[66] This proposal was widely supported in submissions.[67] The Review **recommends** that investors in collective investment schemes should be able to call meetings for the exercise of their powers.[68] The law should provide that the scheme operator must, within 14 days after being requested by not less than 100 investors,[69] 1/10 by number of investors or the holders of 1/10 by value of interests in the scheme, convene a meeting of investors by sending written notice at least 21 days before the proposed meeting. The notice must include the matters to be considered at the meeting and details of proposed resolutions which may lawfully be put to the meeting together with a summary of information relating to those matters and resolutions. The meeting must be held not later than two months after the day on which the requisite number of investors have requisitioned the meeting.

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64. The meeting should be held within two months of the day the operator receives the requisition to call the meeting. The voting requirement for approval of the amendment should be the same as at any other meeting called by the operator to consider an amendment.
65. Corporations Law s 1069(1)(m).
66. Proposal 7.4.
67. eg T Valentine *Submission* 5 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; IFA *Submission* 1 December 1992; National Mutual *Submission* 3 December 1992; FPAA *Submission* 7 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992.
68. The only powers that may be exercisable at a meeting called by investors are to dismiss the operator, to appoint its replacement, to approve a successor to a temporary scheme operator, to amend the scheme's constitution or to terminate the scheme.
69. Rather than 500 as proposed in DP 53: this will ensure that there is no unreasonable obstacle to effective investor action.

Meetings

Annual meetings

11.24 Unlike companies, prescribed interest schemes are not required to hold an annual general meeting. DP 53 proposed that the operator of a collective investment scheme should be required to hold a meeting of investors at least once every calendar year.[70] The Review considered that an annual meeting would provide a regular forum for addressing investors' concerns and questions and could minimise the need for investors to call meetings or, more importantly, contemplate precipitate action. Submissions overwhelmingly opposed requiring collective investment schemes to have annual meetings. Four main reasons were given:

- the expense of holding meetings annually would be disproportionately high relative to the benefit[71]
- annual general meetings of companies serve purposes (such as election of directors, presentation of accounts, declaration of dividends) that are not applicable to collective investment schemes[72]
- annual reports are as effective as annual meetings for disseminating information and less costly[73]
- investors have the ability (both under the current law and under the Review's proposals) to call a meeting if they consider it desirable or necessary.[74]

The Review is persuaded by these arguments and no longer considers that operators should be required to call annual meetings of investors.

Voting rights at meetings

11.25 ***Voting majorities.*** The Review's recommendations involve different voting majorities depending on the nature of the matter being considered by investors.

- The most significant investor powers, to remove the operator or to terminate a solvent scheme, can only be exercised by the approval of the holders of more than 50% of the value of the voting interests in the scheme. This may often be very difficult to achieve, but it is necessary to protect investors' interests by ensuring that they can only change key structural aspects of the

70. Proposal 7.3.
71. Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992; MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
72. National Mutual *Submission* 3 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
73. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; MLC Investments Limited *Submission* 17 December 1992.
74. IFA *Submission* 1 December 1992; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992; MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.

scheme in which they have invested where an absolute majority of them agrees.[75] A lower threshold of three quarters of investors by value voting to terminate is justifiable where a scheme is demonstrably insolvent.[76]

- The approval of the holders of more than 50% of the value of voting interests will also be required for benefits paid in respect of the retirement of scheme operators or their officers. A high threshold is justified in view of the cost to investors with no likely future benefit.[77]

- Material changes to a scheme's constitution will require the approval of at least 75% by value of investors voting, provided that those investors represent at least 25% of the value of interests in the scheme. This requires a substantial level of investor involvement without making the scheme's constitution effectively unchangeable.[78]

- Approval of a merger of collective investment schemes will require a 75% majority of investors who vote. This is the equivalent of the voting requirement for company amalgamations in the Corporations Law Pt 5.1.[79]

- The appointment of a successor to a temporary scheme operator will require a simple majority by value of investors who vote. This less onerous voting requirement will assist in the expeditious appointment of a replacement scheme operator.[80]

11.26 *Operator and associates not to vote.* The operator of a collective investment scheme and its associates may be investors in the scheme. Given the operator's role in management, the Review considers that to permit operators or their associates to vote as investors would involve considerable conflicts of interest.[81] The Review **recommends** that any interests held by the scheme operator or its associates should be non-voting interests except where those interests are held on bare trust and the operator or the associate does not have any discretion in determining how to vote. Non-voting interests should not be counted when determining the total number of interests in the scheme for the purpose of calculating the percentage of investors voting. Similarly, where investors are voting on a successor to a temporary scheme operator, interests held by the applicant scheme operator and its associates should be non-voting interests.

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75. See para 8.5, 11.17.
76. See para 8.6.
77. See para 10.26.
78. See para 11.21, 11.22.
79. See para 11.14.
80. See para 11.16.
81. The Corporations Regulations currently exclude the voting rights of the management company and its associates in certain circumstances: reg 7.12.15(3), (6)(f), 9.

11.27 ***How votes may be exercised.*** The current law appears, in most cases, to require investors to vote in person at a meeting of investors.[82] In some cases, however, investors can vote through an appointed proxy.[83] DP 53 sought comment on whether postal votes should be allowed in relation to various matters.[84] Submissions generally favoured allowing postal votes.[85] The Review considers that investors should have the maximum opportunity to exercise voting rights in relation to their investment. The Review **recommends** that investors in a collective investment scheme should be permitted to vote on a resolution in person, by post or by proxy.

Procedure at meetings

11.28 The Review makes no detailed recommendations for the procedure that should be followed at meetings of investors. The general law lays down certain procedural guidelines for meetings:[86]

- there must be proper notices of meetings
- there must be proper time for discussion at meetings
- everyone's view must be respected before a vote on a particular matter is taken.

These guidelines are equally appropriate for meetings of collective investment scheme investors.

Rules governing substantial acquisitions in collective investment schemes

Takeovers

11.29 ***Introduction.*** Investors in a collective investment scheme may acquire interests in the scheme with the intention of taking over the scheme by removing and replacing the operator. This is analogous to the takeover of a company by the acquisition of shares. DP 53 asked whether takeover provisions based on the Corporations Law Chapter 6 should apply to collective investment schemes. An acquisition or transfer of a controlling interest in a prescribed interest scheme is not regulated by the Corporations Law Chapter 6. No formal takeover offer is therefore

82. Corporations Law s 1069(1)(k) (investor approval for exercise of voting rights); s 1074 (winding up schemes); s 1076(2)(b) (investor approval of acts or omissions of trustee or representative); Corporations Regulations reg 7.12.15(6)(g), (10) (removal of management company).
83. Corporations Law s 1069A requires the approval of holders of interests in a scheme for the amendment of approved deeds; s 1069B permits holders of interests to appoint proxies to vote on the amendment. Section 1076R permits holders of interests to appoint proxies to vote on a special variation proposal for the amendment of the entrenched provisions of a trust deed.
84. Issues 7E, 7G and 7I.
85. eg T Valentine *Submission* 5 November 1992; JP McAuley *Submission* 23 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; IFA *Submission* 1 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; TCA *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
86. These principles were discussed in *John J Starr (Real Estate) Pty Ltd v Robert R Andrew (A'Asia Pty Ltd)* (1991) 6 ACSR 63, 71-2 (Young J).

required. The trust deed of a unit trust may incorporate 'takeover', 'substantial unitholding' and 'compulsory acquisition' provisions which contractually bind unitholders. However, such provisions in deeds of public unit trusts listed on the ASX are largely unenforceable, as Listing Rule 3J(31)(a) prohibits the inclusion in a trust deed of any enforcement penalties or sanctions. The result, therefore, is that the present law does little to regulate this kind of takeover of a scheme.

11.30 ***The Review's position.*** In principle, investors in companies and collective investment schemes should have the same protection in a takeover, including equal opportunity to participate in any relevant benefits and the right to require the acquisition of their interests. However, the Corporations Law Chapter 6 could not be applied to collective investments without major modification. First, it would be necessary to have a considerably higher 'control' threshold than the 20% entitlement that applies to companies.[87] The powers of investors in collective investment schemes are far more limited than those of shareholders in a company. Unlike shareholders, the right of investors to remove the scheme operator will be by an absolute majority of all investors rather than by simple majority of investors who vote. Given this, the control threshold for collective investment schemes should probably be nearer to 50%.[88] Secondly, it may be very onerous to calculate the precise percentage of interests held by particular investors because of the frequency with which the number of issued interests in some collective investment schemes may change.[89] This also creates considerable difficulties in devising any notification provisions for substantial investors.[90] It is also necessary to consider whether these notification requirements should apply to unlisted as well as listed collective investment schemes. The Review received no submissions favouring takeover provisions for collective investments. Nevertheless, the Review is aware of takeovers of large unit trusts where investors were not treated equally. The Review considers that takeovers of collective investment schemes require further detailed consideration of issues that are beyond the scope of this report. It **recommends** that such a review be undertaken.

Compulsory acquisition

11.31 Despite its possible benefits, no submission favoured compulsory acquisition provisions for collective investment schemes. However, the Review considers that the merit of such provisions should be included in the recommended review of takeovers of collective investment schemes.

87. Corporations Law s 615.
88. Macquarie Investment Management Limited *Submission* 24 November 1992 made the point that a 20% threshold would be inapplicable since investors would not be able to influence the management of a fund at that level.
89. BT *Submission* 15 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
90. See para 11.10-11.12.

Enforcing investors' rights through the courts

Current remedies

11.32 Currently investors in prescribed interest schemes may protect their rights by seeking injunctions to require compliance with the law or to prevent a breach of the law under the Corporations Law,[91] the *Trade Practices Act 1974* (Cth)[92] or the general law. They may also take action for damages if a breach occurs.[93] If they invest in a prescribed interest scheme by accepting unlawful offers or invitations, they may avoid subscription contracts by giving notice in writing to the manager.[94] Similar remedies will be available to investors in collective investment schemes. Investors will also be able to enforce the scheme constitution at general law and seek damages for loss resulting from a breach of the constitution.

Oppression remedy

11.33 Shareholders may obtain remedies where they are affected, as a shareholder or in any other capacity, by oppressive or unfair conduct in the conduct of a company's affairs.[95] The court may make a wide range of orders, including winding up the company or regulating the future conduct of its affairs. The ASC may also apply to the court for an order. DP 53 proposed that there should be a similar oppression remedy for investors in collective investment schemes.[96] This proposal was widely supported.[97] The Review's recommendations give investors the right to bring an action directly against a scheme operator and its directors for breach of their statutory duties. The oppression remedy is wider than this. For example, a decision made in good faith and for a proper purpose may still be unfair within the meaning of the oppression remedy.[98] The Review **recommends** that the law should provide a right for investors in collective investment schemes to apply to the court for an order under a provision based on the Corporations Law s 260. The ASC should also have standing to apply to the court under this provision.

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91. s 1324(1), (2).
92. s 80.
93. Corporations Law s 1324(10); *Trade Practices Act 1974* (Cth) s 82.
94. Corporations Law s 1073, 1073A. A declaration that the purchase contract is voidable would entitle the investor to have the purchase money refunded.
95. Corporations Law s 260.
96. Proposal 7.2.
97. eg T Valentine *Submission* 5 November 1992; JP McAuley *Submission* 24 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; IFA *Submission* 1 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; TCA *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
98. *Wayde v NSW Rugby League Ltd* (1985) 10 ACLR 87, 95 per Brennan J. Another example of the width of the oppression remedy is that conduct can be unfairly prejudicial even though it is in accordance with the company's constitution: HAJ Ford & RP Austin *Principles of Corporations Law*, 6th ed, Butterworths, 1992, 632.

Representative action

11.34 In DP 53, the ALRC proposed that investors seeking damages for loss in relation to a collective investment scheme should be required to take a representative action on behalf of all investors under the *Federal Court of Australia Act 1976* (Cth) Part IVA, unless the court grants leave for an individual action, for example, where an investor suffers a loss peculiar to himself or herself.[99] The ALRC's proposal was based on the assumption that the actions of scheme operators will usually affect all investors in proportion to the interests they hold in the scheme. The ALRC took the view that a single investor should not have an unfair advantage over other investors by obtaining a judgment ahead of other investors when the funds available may be insufficient to meet all claims in full. It considered that only representative actions would ensure equity for all investors affected by the actions complained of. The Advisory Committee did not support a requirement for representative proceedings. It considered that each investor should be entitled to take legal action and recover damages individually, regardless of whether any other investor has taken action. This would give individual investors an incentive to undertake private enforcement actions. Submissions opposed the ALRC proposal. The primary concern was that, in the vast majority of cases, the rights of investors are not sufficiently homogeneous to justify such actions.[100] One submission said that the requirement would cause technical problems in relation to costs.[101] The Review accepts that investors should not be required to take representative actions against scheme operators. The representative procedure will be available to those investors who choose to use it.[102]

Rights in a dispute with the operator

Internal dispute resolution procedure

11.35 Many problems in collective investment schemes can be resolved quickly by giving investors information about the scheme. Also, it is important that investors have confidence that the operator will deal efficiently and thoroughly with their problems. DP 53 proposed a system of internal dispute resolution for

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99. Proposal 7.1. The *Federal Court of Australia Act 1976* (Cth) Pt IVA, permitting representative actions, was a consequence of the ALRC's recommendations in ALRC 46 *Grouped Proceedings in the Federal Court*. Part IVA allows proceedings to be commenced on behalf of a class of persons affected by the same issue, even if they are not all identified.
100. National Mutual *Submission* 3 December 1992; AMP Society *Submission* 30 November 1992; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992; BT *Submission* 15 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; MLC Life Limited *Submission* 18 December 1992.
101. Law Council of Australia *Submission* 16 December 1992.
102. This choice will be available if the collective investments provisions form part of the Corporations Law. Jurisdiction under the Corporations Law is conferred on the Federal Court by the *Corporations Act 1989* (Cth) Pt 9, Div 1 and its State equivalents. Any person commencing action in the Federal Court would have the option of proceeding under the *Federal Court of Australia Act 1976* (Cth) Part IVA.

investors in collective investment schemes. The proposal received wide support in submissions.[103] The Review **recommends** that scheme operators should be required to

- maintain an internal dispute resolution procedure to deal with investor enquiries and complaints
- include in each prospectus and annual report details of the scheme's internal dispute resolution procedure.

External dispute resolution procedures

11.36 Disputes that cannot be resolved by any internal procedure will arise. Currently the main way of solving such disputes is through legal action. DP 53 noted two current alternative dispute resolution procedures.

- A procedure operated by LIFA is available to the holders of investment linked life policies.[104]

- The Banking Ombudsman has jurisdiction over schemes offered by a subsidiary of a bank that is a party to the Banking Ombudsman scheme where the subsidiary has been specifically designated. To date, there has been no such designation.[105]

There are no comparable external alternative dispute resolution procedures available to investors in all collective investment schemes. DP 53 sought comment on the desirability of providing an external dispute resolution procedure.[106] Although some submissions favoured such a procedure,[107] most were either

103. eg T Valentine *Submission* 5 November 1992; JP McAuley *Submission* 23 November 1992; IFA *Submission* 1 December 1992; AMP Society *Submission* 30 November 1992; FPAA *Submission* 7 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992; Financial Institutions Division, The Treasury *Submission* 24 December 1992.

104. The procedure involves an approach by the investor, in the first instance, to the life insurance company and subsequently, if the matter is unresolved, to LIFA. If this proves unsuccessful, the matter is referred to a Complaints Review Committee. The decision of this Committee is not binding on the investor but the insurance companies who are members of the scheme have agreed to adhere to a decision of the Committee. The insurance company's contract under which it participates in the scheme provides that it will not contest an adverse decision by the Committee. It is doubtful if the company's customer could enforce the Committee's decision if the company breached this undertaking, as customers are not parties to the contract.

105. This is a private scheme, based on a contract between participating banks. It is informal and the emphasis is on conciliating complaints. The Ombudsman can make an award against a bank for sums up to $100 000. The Ombudsman's determinations are binding on the bank but not on the customer.

106. Issue 7J.

107. eg IFA *Submission* 1 December 1992; FPAA *Submission* 7 December 1992.

equivocal or opposed.[108] The Review has therefore concluded that there is not at present enough evidence that an alternative dispute resolution procedure is needed for collective investment schemes.

Liability of investors

11.37 The liability of investors to creditors of a trust is governed by the general law and the terms of the trust deed. Trustees are personally liable to creditors for trust debts. The trustee may have a right to be indemnified for properly incurred expenses and liabilities out of trust assets or by the trust beneficiaries.[109] The creditors are subrogated to any rights of indemnity the trustee may have. Whether investors are liable to indemnify the trustee is determined by the trust deed in each case.[110] This is unsatisfactory for public investment vehicles. The Corporations Law, by contrast, limits the liability of shareholders.[111] DP 53 proposed a statutory provision to ensure that investors are not under any personal obligation to indemnify the scheme operator or a creditor of the scheme operator where scheme assets are insufficient to cover scheme debts.[112] This proposal was strongly supported in submissions.[113] The Review **recommends** that the law should limit the liability of investors in collective investment schemes that are trusts to the unpaid amount, if any, of their investment in the scheme.

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108. eg M Starr *Submission* 12 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; Law Council of Australia *Submission* 16 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; Mercantile Mutual Holdings Limited *Submission* 16 December 1992.
109. *JW Broomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd* (1985) 3 ACLC 355.
110. *McLean v Burns Philp Trustee Co Ltd* (1985) 2 NSWLR 623.
111. s 117(5).
112. Proposal 7.14.
113. eg T Valentine *Submission* 5 November 1992; JP McAuley *Submission* 23 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; IFA *Submission* 1 December 1992; National Mutual *Submission* 3 December 1992; FPAA *Submission* 7 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; Mercantile Mutual Holdings Limited *Submission* 16 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992; R Finlayson *Submission* 18 December 1992. One submission argued that the proposal should be accompanied by the introduction of greater protection for creditors: Arthur Robinson & Hedderwicks *Submission* 16 December 1992. The Review recommends that creditors should be entitled to assume that a scheme's constitution has been complied with: para 4.6.

12. No compulsory third party needed

Introduction

12.1 All collective investment schemes must have at least a scheme operator and investors. The new regulatory regime recommended by the Review will impose on the operator directly a number of clear, inescapable duties, including compliance with the law and the scheme's constitution. It will also require that operators be licensed by the ASC. This chapter discusses whether, in the light of these recommendations, there is also a need for a compulsory third party, such as a trustee, for all schemes under the new regime. It sets out the present law and its shortcomings and the alternative ways in which reform can be approached. The Review has concluded that there is no need for a compulsory third party under the new regime.

The present law

12.2 Under the present law, prescribed interest schemes must have both a manager and trustee or investors' representative.[1] The manager establishes and promotes the scheme. It also selects the trustee or representative. The trustee holds the property of the scheme,[2] supervises the manager[3] and acts as the representative of investors. The manager must hold a securities dealers licence[4] and the trustee must be approved by the ASC.[5] Interests in a scheme may not be issued unless the deed constituting the scheme has been approved by the ASC.

Shortcomings of the present law

Present structure unsatisfactory

12.3 ***Introduction.*** The current mandatory trustee and management company arrangement for prescribed interests is unsatisfactory. The rules governing the distribution of powers and responsibilities between the two parties have developed in an ad hoc fashion. In theory, the system should achieve the policy goals the Review has set out for the regulation of collective investment schemes. In particular, it should afford investors appropriate protection. Unfortunately, in practice, the scheme has failed to prevent some significant instances of non-

1. Unless an exemption is granted, as in the case of trustee common funds: see ASC Policy Statement 32. The 'two party' structure for prescribed interests contrasts with the legal regime for public companies which are not required to have a trustee or representative of shareholders.
2. Unless the investors hold the legal title themselves.
3. The extent of the trustee's legal obligation to supervise the manager is not clear. It appears that the ASC, trustees and managers have different views on the issue.
4. Because the ASC takes the view that issuing units in a prescribed interest scheme constitutes carrying on a business of dealing in securities.
5. Corporations Law s 1065, 1066. The Review notes that the ASC is currently reviewing its approval process for trustees.

compliance with the law. It appears to offer additional security for investors because it involves a trustee that is independent of the management company supervising the actions of that company on their behalf. This additional security, however, is at times illusory. The system contains fundamental legal and commercial contradictions.

12.4 ***Legal confusion and uncertainty.*** The traditional role of a trustee was to undertake full responsibility for the operation of the trust. In time, some trustees engaged other persons with relevant expertise to perform some functions on their behalf. Superannuation schemes are an example. In many large superannuation schemes, a professional fund manager is engaged by the trustee to make the asset selections, subject to the trustee's approval. The manager is dependant on the trustee for its appointment and is accountable to it. The trustee remains fully accountable to the beneficiaries of the trust for all aspects of the trust's operations. In unit trusts responsibility to the beneficiaries is split between the management company and the trustee. The law, however, has not taken account of these new arrangements. It still assumes that the relationship between trustee and manager, in which the manager is engaged by the trustee, persists. For example, one of the key statutory obligations of a trustee is to exercise

> all due diligence and vigilance in carrying out. . . its functions and duties and in protecting the rights and interests of [investors].[6]

The security and commercial benefit this obligation provides for investors is unclear. Trustees themselves are quite equivocal on what, if any, powers or responsibilities this obligation imposes on them. One leading trustee company stated that

> it is inappropriate for the trustee to be involved in determining the commercial wisdom of each of the manager's investment decisions.[7]

Nevertheless, it considered that a trustee should be able to reject an investment proposal on the ground that it is 'manifestly not in the interests of investors'. In this it was supported by another leading trustee company.[8] The dual responsibility structure has led to confusion about what protection is afforded to investors and may well be misleading as it does not emphasise that the management company not only has responsibility for the management of the commercial aspects of the scheme but for ensuring that its activities comply with the law and the scheme's deed.The very fact of split responsibility is a problem.

12.5 ***Inadequate fee structure.*** There is serious doubt whether the existing fee structure for trustees enables them to carry out their statutory functions satisfactorily. The fees charged by trustees of prescribed interest schemes are generally determined as a small percentage (often no more than 0.1%) of the value

6. Corporations Law s 1069(1)(e)(i).
7. Perpetual Trustees Australia Limited *Submission* 10 December 1992.
8. Permanent Trustee Company Limited *Submission* 12 November 1992. Both submissions took the view that trustees should not be liable for acting on that opinion, or for failure to form such an opinion or act on it, unless there was a lack of good faith on their part. As a result trustee companies would acquire power without responsibility.

of the scheme assets, regardless of the workload. There is a widespread view among industry participants that this fee structure does not provide enough revenue for trustee companies to carry out their statutory obligations effectively.[9] The trustee companies themselves acknowledge this as a problem.

> We believe that fees have been negotiated on the basis of a certain understanding of what the role will require. Subsequently, this role has changed because of increased responsibilities without a corresponding increase in remuneration. Under existing deeds the only way that an increase in fees can occur is by investors' approval. Realistically it must be recognised that, notwithstanding any commercial justification for the increase, unit holders are unlikely to approve the increase if it means a reduction in their return.[10]

Two approaches

Introduction

12.6 Reform is clearly needed. Virtually all submissions agreed. The Review considered two possible approaches:

- revise the role and functions of trustees and management companies, within the present regime of split responsibilities, by identifying more precisely their respective powers, duties and liabilities
- focus instead on the role of a single scheme operator and appropriate compliance measures and, after that, ask whether a compulsory third party is still necessary.

Refining the current system

12.7 Some submissions, while acknowledging problems in the existing arrangement, argued that it should be improved and refined rather than replaced. The main measures suggested involved clarifying the respective roles of the management company and the trustee, either by amending existing mandatory covenants or by introducing statements setting out each party's role more clearly.[11] Any such reworking will not overcome the inherent problems of divided powers and responsibilities in a dual system, and the inevitable legal complexity and uncertainty that this creates. One submission to IP 10 pointed out

> [i]f managers are made primarily liable to unit holders and required to undertake fiduciary obligations as opposed to merely contractual ones, it is submitted that they should be more circumspect in making decisions. Managers are often prone to take a

9. eg IFA *Submission* 1 December 1992.
10. Perpetual Trustees Australia Limited *Submission* 1 December 1992.
11. See, eg, Permanent Trustee Company Limited *Submission* 12 November 1992; Perpetual Trustees Australia Limited *Submission* 1 December 1992; TCA Submission 10 December 1992; National Mutual *Submission* 3 December 1992; Wessex Fund Management Limited *Submission* 26 November 1992. Permanent Trustee Company Limited suggested that the roles of the managers and the trustee may not always be fully appreciated by lawyers, the courts and the regulators, as well as the investors: *Submission* 12 November 1992.

> robust view on matters relating to interpretation of the trust deed and action authorised under it. If required to act as a trustee, they should be more likely to act with a prudent regard for the terms of the deed.[12]

There is a further concern. Use of trust terminology may create the false impression that common law trust principles apply in full. Trustees of prescribed interest schemes, unlike traditional trustees, do not bear ultimate responsibility. Likewise, to the extent that trustees rely on management companies for their appointment, they may be compromised in their 'supervisory' role, whatever their powers and responsibilities in law.[13] The Review accepts that statutory trustee companies fully appreciate their responsibilities. Nevertheless, the interests of investors may be substantially prejudiced by any of these consequences. A refined system will not create a better, or even necessarily an acceptable, compliance system.

A fresh approach preferred

12.8 ***Introduction.*** The Review proposes a new regime, a fresh approach to the regulation of collective investment schemes. A new approach is needed to support the policies and principles that should underlie the regulation of these schemes. Under this new regime, it is simply unnecessary to require a third party. The new regime places full responsibility for the operation of a scheme on one scheme operator.

12.9 ***Legal clarification and simplification.*** The new regime imposes clear and non-delegable legal obligations on scheme operators and their directors with criminal and civil liability for breach. It also makes compliance with the law and the scheme's constitution the focal point of regulation. A scheme operator may contract out certain functions, but this private arrangement has no bearing on the operator's ultimate liability in law for the exercise of these functions.

12.10 ***Commercial flexibility.*** A significant benefit that flows from this approach is that it encourages flexibility and the adoption of the most appropriate structure for each scheme. It permits an external party to be involved in compliance where this is appropriate, without creating a duplication of functions and additional costs where scheme operators themselves have adequate and cost-effective measures to check compliance with the law and the scheme constitution.

12.11 ***Consistency with other corporate structures.*** The remedies available against scheme operators would be similar to those against other corporations, including investment companies. The single operator arrangement also applies to common funds administered by trustee companies. One submission to IP 10 pointed out that

> if fiduciary obligations are imposed upon managers, and beneficiaries have conferred on them other rights similar to those of shareholders in companies, then the basis of the existence of separate trustees falls away. Other non-prescribed interest forms of investment, such as shares in a company, do not have 'trustees' appointed to watch

12. Law Council of Australia *Submission* 21 February 1992.
13. The Review understands that some trustee companies derive more than 50% of their total income from unit trust administration.

over the rights, say, of the shareholders. Perhaps the difference lies in the fact that the directors of a company are directly responsible to the company for their decisions and owe fiduciary duties to the company in the exercise of their powers and duties. When a person is under fiduciary duties of his own, it should not be necessary for another fiduciary to watch that those fiduciary duties are performed.[14]

A compulsory third party is unnecessary

12.12 In the new regime, a compulsory third party is unnecessary.[15] Trustees may continue to be involved in collective investment schemes, as scheme operators, for example, of their common funds, or as parties engaged to undertake an external compliance role for a particular scheme. There will always be a single operator responsible for all aspects of the scheme's compliance with the law and its constitution. No other party is required. Accordingly, the Review **recommends** that the Corporations Law should not require the operator of a collective investment scheme to involve another entity in the operation of the scheme.

14. Law Council of Australia *Submission* 21 February 1992.
15. The Treasurer has indicated that the regulation of pooled superannuation trusts (PSTs) will be changed so that the trustee will be wholly responsible to the unitholders for the management of the PST and there will be no requirement for the manager and the trustee of a PST to be separate persons: J Dawkins, Treasurer *Strengthening Super Security: New Prudential arrangements for Superannuation* AGPS Canberra 1992.

13. Intermediaries

Introduction

13.1 Many investments in securities, including interests in collective investment schemes, are made through an intermediary,[1] who is often the only person an investor discusses a prospective investment with. Investors rely on intermediaries to provide accurate information and appropriate advice. The role of intermediaries is becoming increasingly important as more and more people with little financial sophistication seek to invest significant amounts of money, for example, their lump sum superannuation payment.

> [M]any investors rely almost exclusively on the recommendations of their advisers. Without careful regulation and close scrutiny, intermediaries have the capacity to negate all other regulatory controls on the collective investment industry.[2]

In 1991 the Martin Committee recommended that there should be a general review of quality control of financial advisers and agents.[3] In December 1992 the Trade Practices Commission reported on various aspects of the conduct and operation of life insurance agents.[4] This chapter makes recommendations to improve the regulation of intermediaries of securities and thereby improve protection for investors against the consequences of uninformed decision making. Intermediaries of securities are regulated by the Corporations Law. The recommendations in this chapter are made in respect of all securities, not just interests in collective investment schemes, because it is logical to regulate in the same way all those who sell securities. It is also important that intermediaries who sell or advise on similar investments that are not regulated by the Corporations Law[5] are subject to equivalent controls and minimum standards, even though they are regulated under different laws. The principles on which the recommendations in this chapter are based should be reflected in the regulatory framework for these investments.[6]

Licensing of intermediaries

Corporations Law

13.2 ***Dealers and advisers.*** Anyone who carries on a business of dealing in securities[7] or a business of advising other persons about securities[8] must be licensed under the Corporations Law.[9] Because they are securities, a person who

1. Intermediaries include accountants, share brokers, trustee companies and people who are also agents for life insurance companies.
2. Stokes & Company (Securities) Pty Ltd *Submission* 26 November 1992.
3. Martin Report, recommendation 17.
4. TPC *Superannuation and life insurance* December 1992. The Review refers to the recommendations of the Trade Practices Commission where relevant.
5. eg superannuation schemes and some insurance products. See discussion in ch 3 of investments that are similar to collective investment schemes.
6. In some instances the Review makes specific recommendations in respect of intermediaries that do not sell collective investment schemes: see, eg, para 13.23.
7. Corporations Law s 93.
8. Corporations Law s 77.
9. s 780, 781.

sells interests in prescribed interest schemes as a business can only do so if he or she is a licensed securities dealer.[10] A person who has a business of advising on interests in prescribed interest schemes must, however, be either a licensed dealer or a licensed investment adviser.[11] It is ASC policy that, if a person who gives advice on a business basis on securities receives a benefit other than from the investor, he or she must have a dealers licence, not an investment advisers licence.[12]

13.3 *Authorised representatives.* The Securities Industry Code required the representatives of securities dealers, as well as the dealer, to be licensed. This system proved to be cumbersome and ineffective. The Corporations Law provides for licensed securities dealers and investment advisers to authorise representatives to act on their behalf.[13] It does not prescribe any standards for representatives.[14] The licensee has an incentive to ensure a high standard in its representatives because it could lose its licence as a result of its representatives' actions.[15] This approach is appropriate. Standards for representatives do not need to be specified in the law.

Recommendations

13.4 It is appropriate that the provisions of the Corporations Law which presently require intermediaries who carry on a business of dealing or advising in securities, including interests in collective investment schemes, to have a dealers or advisers licence should continue. Two qualifications will, however, need to be made.

- *Scheme operator dealing in interests in its own scheme.* The ASC administers the Corporations Law on the basis that 'dealing in securities' includes the issue, and buying back, of interests in a scheme by its operator. That interpretation of the Corporations Law was developed in the context of a dealers licence being the only licence available to be used to control prescribed interest scheme operators. The Review's recommendation for a separate class of licence — a scheme operators licence — alters this position. The Review **recommends** that the prohibition in the Corporations Law on dealing in securities without a dealers licence should not be infringed

10. The Corporations Law s 781 provides that a person must not carry on a securities business unless the person holds a dealers licence or is an exempt dealer. A securities business is the business of dealing in securities: s 93. Prescribed interests are securities: s 92(1).
11. A dealers licence entitles the holder to carry on a business of dealing in securities: Corporations Law s 780, 9, 93. 'Deal' in securities includes to acquire, dispose of or subscribe for or underwrite securities: s 9. An investment advisers licence entitles the holder to carry on a business of advising other persons about securities: Corporations Law s 781, 9, 77.
12. See NCSC Release 333 para 14, which has been adopted by the ASC. There are many more licensed securities dealers than there are licensed investment advisers.
13. Corporations Law s 806, 807.
14. The ASC may, however, impose conditions on a licence about what the holder of the licence is to do, by way of supervision and otherwise, to prevent the holder's representative from contravening a securities law or another condition of the licence and to ensure that each representative of the holder has adequate qualifications and experience having regard to what the representative will do on the holder's behalf in connection with a securities business or investment advice business carried on by the holder: Corporations Law s 786(2)(e), (f).
15. Corporations Law Pt 7.3, Div 4.

merely because the licensed operator of a collective investment scheme issues, buys or redeems interests in the scheme. If, apart from this, a collective investment scheme operator carries on the business of dealing in securities,[16] the operator must also hold a dealers licence.

- *Advising.* Similar reasoning applies to the prohibition in the Corporations Law on carrying on an investment advice business without a licence. The Review **recommends** that that prohibition should not be infringed merely because the operator of a scheme gives advice, either directly or through its staff, about interests in any scheme of which it is the operator. Later recommendations in this chapter ensure that other protective controls apply when scheme operators give advice.

If a scheme operator authorises representatives (in the same way as a securities dealer can authorise representatives), the Review **recommends** that the procedures and requirements for such representatives should be the same, as nearly as possible, as for representatives of licensed dealers. In particular, the scheme operator should have the same liability as a licensed dealer has for its representatives' actions.

Corporations Law standards for dealers and investment advisers

Are the standards adequate?

13.5 Under the Corporations Law, persons applying for a dealers or investment advisers licence must be solvent and have educational qualifications and experience adequate for a licence of the kind applied for. In addition, the ASC must have no reason to believe that the person is not of good fame and character or will not perform his or her duties efficiently, honestly and fairly.[17] It must have regard to any conviction in the past 10 years for serious fraud.[18] If the applicant is a body corporate, the applicant must not be externally administered and the ASC must be satisfied that the educational qualifications and experience of each responsible officer of the applicant are adequate having regard to the duties that the officer would perform in connection with the licence.[19]

Minimum standard of education

13.6 The Corporations Law lists no specific educational qualifications and experience needed to gain an advisers or dealers licence. DP 53 proposed that, in the longer term, these matters should be prescribed for intermediaries.[20] The Review suggested that this would promote consistency and public confidence in intermediaries. It anticipated that, beyond a prescribed minimum, the level of

16. eg as the operator of an equity trust would.
17. Corporations Law s 783.
18. Corporations Law s 783(4). 'Serious fraud' is defined in s 9.
19. Corporations Law s 784.
20. Proposal 10.1.

education should vary depending on the type, or range, of collective investments the licensee would be entitled to sell or advise on. The proposal received wide support.[21] Many submissions urged that prescribed qualifications be introduced promptly.[22] The Review **recommends** that specific educational qualifications and experience necessary to gain a dealers licence under which the licensee will be allowed to advise persons about securities or an investment advisers licence should be prescribed.[23] The development of licence categories and appropriate standards for each category should be done by the ASC in consultation with industry participants and consumers of intermediary services.[24] This should be done as soon as possible.

Making securities recommendations

Duty to give appropriate advice in light of the investor's circumstances

13.7 ***'Know your client'.*** A person offering advice or making a recommendation to an investor about securities should know the needs and circumstances of the investor. Referred to as the 'know your client' rule, the Corporations Law provides that a securities adviser is liable to pay damages to a client who loses money after acting on that adviser's recommendation if the adviser did not have a reasonable basis for making the recommendation.[25] An adviser does not have a reasonable basis for making a securities recommendation unless

> (a) in order to ascertain that the recommendation is appropriate having regard to the information the securities adviser has about the person's investment objectives, financial situation and particular needs, the securities adviser has given such consideration to, and conducted such an investigation of, the subject matter of the recommendation as is reasonable in all the circumstances; and
> (b) the recommendation is based on that consideration and investigation.[26]

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21. Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; JP McAuley *Submission* 23 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; JK Denyer *Submission* 3 November 1992; National Mutual *Submission* 3 December 1992; AMP Society *Submission* 30 November 1992; National Information Centre on Retirement Investments *Submission* 24 November 1992; IFA *Submission* 1 December 1992; FPAA *Submission* 7 December 1992; MLC Investments Ltd *Submission* 17 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992; MLC Life Ltd *Submission* 18 December 1992. One submission criticised the standards in the industry generally. It also said that the ASC lacked a clear policy on what minimum standards should be required and failed to use its enforcement powers when complaints about individual intermediaries are made: Australian Investors Association *Submission* 16 December 1992.
22. eg T Valentine *Submission* 5 November 1992; IFA *Submission* 1 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
23. The Review does not consider that educational qualifications and expertise to gain a scheme operators licence need to be prescribed (see para 10.50). A scheme operators licence will, however, only allow the holder to advise on its own securities, about which, it is fair to assume, it will be sufficiently well informed.
24. The FPAA is already consulting with the ASC about prescribed standards for licensees: FPAA *Submission* 7 December 1992.
25. s 851, 852. A securities adviser is a dealer, an investment adviser or a representative of either: Corporations Law s 9, 94.
26. s 851(2).

13.8 ***Securities advisers should have to enquire.*** The Review agrees with the basic thrust of this provision but considers it has several deficiencies. First, it does not impose a positive obligation to ask clients about their investment objectives, financial situation and personal needs. Without this, an adviser could claim to have a reasonable basis for making a securities recommendation to a person about whose situation the adviser knew little or nothing. In 1990 the NCSC expressed its view that the *Securities Industry Act 1980* (Cth) s 68E, the equivalent of the Corporations Law s 851, imposed a positive duty on advisers to ask clients for such information if it was clear that the client needed to rely totally on advice sought from an adviser concerning a particular matter.[27] The Review supports the policy set out by the NCSC. However, its interpretation of s 851 may be questionable. What s 851 requires is that the adviser, in order to check whether a recommendation is appropriate *having regard to the knowledge of the client's circumstances that the adviser presently has*, must investigate the subject matter of the recommendation, that is, the securities. The adviser need not inquire further of the client. DP 53 proposed that the Corporations Law be amended to impose on advisers a positive obligation to make appropriate inquiries about the client's investment objectives, financial situation and needs.[28] Submissions overwhelmingly agreed.[29] Also, the recent TPC report on life agents recommended that all life insurance intermediaries should have to conduct 'needs based' and 'know your client' analyses to establish relevant facts about and needs of their clients and to recommend products which match their needs and financial capacities.[30]

13.9 ***When does service involve a recommendation?*** DP 53 suggested that an intermediary who does not advise or make a recommendation to an investor but merely sells an investment should not be subject to a 'know your client' requirement, just as the person is not presently subject to s 851. One submission warned against interpreting 'recommendation' too narrowly. It considered that counter staff or client service officers who make favourable statements to individuals are in fact making recommendations and should, therefore, be required to carry out a 'know your client' exercise before advising people whether to make a purchase.[31]

13.10 ***Recommendation.*** The Review **recommends** that the Corporations Law should be amended to prohibit a securities adviser or the holder of a scheme operators licence from making a securities recommendation to a client that the client may reasonably be expected to rely on unless

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27. NCSC Release 352 para 12.
28. Proposal 10.2.
29. eg Minter Ellison Morris Fletcher *Submission* 19 November 1992; LIFA *Submission* 18 December 1992; TCA *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; MLC Investments Ltd *Submission* 17 December 1992; MLC Life Ltd *Submission* 18 December 1992; ISC *Submission* 12 November 1992; IFA *Submission* 1 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992; Stokes & Company (Securities) Pty Ltd *Submission* 26 November 1992.
30. TPC Report, recommendation 2(a).
31. FPAA *Submission* 7 December 1992. It suggested that the only exception to this obligation should be where a client desires an 'execution only' service and is warned that no advice or recommendation is being given.

- the adviser or operator has made reasonable inquiries about, and other reasonable investigations of, the client's investment objectives, financial situation and needs and
- the recommendation is based on the results of those inquiries and investigations.

Whether what has been done in a particular case amounts to making such a recommendation will depend on the circumstances. The holder of a scheme operators licence will have to ensure that its employees know when they are making securities recommendations and that they take the necessary care when making them. One submission suggested that the law should expressly provide that, if nothing in an adviser's range of product competence is suitable for a client, the adviser should have to refer the client to another adviser with a different area of competence or make no recommendation.[32] The Review considers the obligation imposed on intermediaries by the recommendation just made will in practice preclude an adviser making a recommendation if he or she does not have a suitable product, because he or she will not have a reasonable basis for recommending one of his or her products.

13.11 ***Recommendation to be in writing.*** One submission argued that the quality of advice is enhanced if the advisory process is adequately documented and a copy of the analysis and recommendation is provided to the client on request.[33] The Review agrees. The TPC recently made the following recommendation in respect of life insurance intermediaries.

> To create an appropriate 'paper trail' of the point-of-sale advice and information disclosure provided to consumers . . . all intermediaries should be required to document (and to provide copies for consumer, life office and intermediary) the relevant facts and bases for recommendations and to ensure that the facts and recommendation bases are explained to the clients.[34]

The Review **recommends** that the Corporations Law should require that, if a securities adviser or the holder of a scheme operators licence makes a securities recommendation to a client who can reasonably be expected to rely on it, it should have to give the client a written statement of the recommendation. The statement should include the particulars of the enquiries made by the adviser and the information required under recommendation made in paragraph 13.19.

Best advice

13.12 DP 53 proposed that the law should prohibit an intermediary from recommending a product to a client unless it is, in the intermediary's professional judgment, the product within the range of products on which the intermediary is

32. FPAA *Submission* 7 December 1992.
33. ibid.
34. TPC Report, recommendation 2(c).

competent to advise that will best suit the client's needs.[35] Submissions on this proposal were mixed. Some said that this requirement would narrow the range of advice offered, limit the market opportunities of some institutions and tend to encourage agents into recommending large players in the industry.[36] Several submissions considered that it would be problematic to enforce because of the difficulty of showing that a product was not the most appropriate 'in the professional judgment of the adviser'.[37] The Review accepts these concerns. It does not recommend that a 'best advice' obligation be imposed on intermediaries.

Independence of financial intermediaries

Independent intermediaries

13.13 The word 'independent', when used in the context of investment advice, connotes separation of the person giving the advice from the promoter of the investment opportunity. It suggests that the advice is objective and made only in the light of the client's interests. At the moment, advisers who may not fulfill these expectations are able to call themselves independent.

Distinction between giving advice and selling a product

13.14 Giving advice and selling a product are very different activities. The difference affects the degree of independence expected of the intermediary. This is particularly so if the sale involves a commission for the intermediary.

> Strictly speaking, advisers who operate on [a commission] basis are not remunerated for the *advice* they give their clients, but for *placing* their clients' investment or insurance business.[38]

Unless advice is given free of any consideration by the intermediary of the benefit that may flow to him or her as a result, that advice will not be truly independent. Any possible benefit, no matter how minor or seemingly insignificant, has the potential to influence an intermediary in making a recommendation and could, in the extreme, drive a recommendation.

Use of term 'independent'

13.15 A potential conflict of interest exists when an intermediary may be influenced in recommending an investment by a consideration other than the value of the investment for the client in the client's circumstances. The potential for

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35. Proposal 10.4. In the UK intermediaries selling 'packaged products', which include life policies, authorised unit trusts and recognised overseas collective investment schemes, are subject to a 'best advice' rule, under which a recommendation must not be made unless there has been a conscientious search across packaged products that are within the adviser's competence to recommend and the packaged product recommended is believed to be at least as good as any other available: Securities Investment Board Core Rule 17.
36. Treasury *Submission* 24 December 1992; National Mutual *Submission* 3 December 1992.
37. eg T Valentine *Submission* 5 November 1992; St George Funds Manager Limited *Submission* 18 December 1992.
38. Stokes & Company (Securities) Pty Ltd *Submission* 31 October 1991.

such a conflict is particularly significant when an intermediary enters an arrangement under which he or she will receive a commission from the promoter on the sale or recommendation of a particular investment.[39] Many intermediaries who currently describe themselves as 'independent' mean merely that they operate their business away from the office of the promoter of a particular product or that they are able to offer products from a range of promoters or institutions, that is, that they are not sole agents. The general community understanding, however, is that 'independent' connotes a lack of possible conflict of interest and is, therefore, inconsistent with receiving commission.

Proposal and recommendation

13.16 DP 53 proposed that only intermediaries who do not receive any benefit, monetary or otherwise, other than from their clients should be able to hold themselves out as independent.[40] Submissions generally supported the proposal.[41] Some considered that full and effective disclosure would provide enough information for clients to judge the extent of bias or impartiality of the advice provided.[42] It was also suggested that the proposal would reduce competition.[43] The Review is not persuaded by these arguments. To describe oneself as independent when, according to the ordinary community understanding of the word, one is not independent is a form of misleading market activity. The Review recommends two restrictions on intermediaries holding themselves out as independent. First, it **recommends** that the Corporations Law should prohibit a dealer or investment adviser from holding himself or herself out as independent, whether by describing himself or herself as independent or otherwise, if he or she will receive, or has entered into any arrangement to receive, as a result of a recommendation to a client, a benefit other than from the client on account of buying or selling any securities.[44] 'Benefit' should include all benefits, not just commissions. Intermediaries who only receive commissions and arrange for commissions to be rebated and instead receive payment for services from their client should not, however, be prevented from describing themselves as independent. The second prohibition arises from a suggestion in one submission that the expression 'independent' should not be available to intermediaries who are owned (partly or wholly) by the operator of a collective investment scheme.[45] The Review

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39. In the UK intermediaries are divided into independent financial advisers (who give advice across a range of products) and tied agents (who sell the products of only one company): *Financial Services Act 1986* (UK). Under this division, independent financial advisers may receive commissions.
40. Proposal 10.5.
41. eg T Valentine *Submission* 5 November 1992; National Mutual *Submission* 3 December 1992; Minter Ellison Morris Fletcher *Submission* 19 November 1992; AMP Society *Submission* 30 November 1992; St George Funds Manager Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992; ASCPA & ICAA *Submission* 15 February 1993; Treasury *Submission* 24 December 1992; ISC *Submission* 12 November 1992.
42. eg FPAA *Submission* 7 December 1992; MLC Investments Ltd *Submission* 17 December 1992; Mercantile Mutual Holdings Ltd *Submission* 16 December 1992.
43. FPAA *Submission* 7 December 1992.
44. The Review notes that the TPC recommended that any intermediaries who are remunerated by commission or are otherwise obligated or responsible to, or employed by, a life office should be prohibited from describing their position or service as 'independent': TPC Report, recommendation 1(b).
45. Stokes & Company (Securities) Pty Ltd *Submission* 26 November 1992.

agrees. The potential for an intermediary that is controlled by the offeror of securities to give advice that is influenced by that relationship is significant enough to warrant prohibiting that intermediary from calling itself independent, even if it is remunerated only by its clients. The Review **recommends** that a dealer or investment adviser that is a body corporate must not hold itself out as independent if a body in whose securities it may lawfully deal or about whose securities it may lawfully advise other persons or publish reports is in a position to control it.

Restricting method of remuneration

13.17 An intermediary may be paid by a client, by the offeror of the securities or by both. Payments by commission inevitably involve the possibility of bias. One submission particularly criticised the commission system of remunerating agents.

> [A]dvisers must be objective. They must not be in a position where there is a conflict of interest (ie to be in a situation where the income earned from recommendations varies according to the investment recommended). Advice on physical health from a person who derives income from commissions paid by drug manufacturers with a tendency to recommend the drug which pays the highest commission would be completely unacceptable.[46]

DP 53 asked whether there is a need to control the way in which intermediaries determine their fees. Most submissions expressed the view that, so long as intermediaries disclosed fully and fairly the remuneration and other benefits they get, legislative controls on fee or benefit levels were unnecessary.[47] The Review agrees. Disclosure of fees, in particular commissions, is more important than what kind of payments are made.[48]

Disclosure by intermediaries

Disclosure of benefits

13.18 Commissions and other benefits paid to intermediaries have the potential to place intermediaries in a position of conflict of interest. They may take into account, in making a recommendation, factors other than the client's needs. Clients should be made aware of this, to let them judge for themselves. Under the Corporations Law a securities adviser must, when making a securities recommendation, give the client details of

- commissions, fees or other benefits or advantages, whether pecuniary or not, that the adviser, or an associate, has received or will receive on account of making the recommendation[49]

46. Australian Investors Association *Submission* 16 December 1992.
47. Minter Ellison Morris Fletcher *Submission* 19 November 1992; Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; T Valentine *Submission* 5 November 1992; NE Renton *Submission* 3 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; Mercantile Mutual Holdings Limited *Submission* 16 December 1992; FPAA *Submission* 7 December 1992; MLC Investments Ltd *Submission* 17 December 1992.
48. See para 13.18.
49. s 849(2)(c).

- any other pecuniary or other interest of the adviser, or an associate, that may reasonably be expected to be capable of influencing the recommendation.[50]

The Review supports this obligation.

Disclosure of how much of the client's money is actually invested

13.19 The Review recommends elsewhere that scheme operators should have to disclose in the prospectus how their fees and charges are worked out.[51] Disclosure of such benefits does not, by itself, give the whole picture. It is most important that investors also know how much of their money is actually invested. Some intermediaries in the collective investments industry already provide investors with these details.[52] DP 53 proposed that the Corporations Law s 849 should be amended to make this further disclosure mandatory.[53] This proposal received widespread support.[54] It should not be left to an investor to seek from the intermediary information about how much of his or her funds are actually invested. The information should be volunteered. The Review **recommends** that the Corporations Law should be amended to require securities advisers and scheme operators, when they make a securities recommendation, to disclose to their clients how much of the client's investment will be deducted for fees, commissions and other charges. The amount of each fee and charge, and its purpose, should be disclosed in writing before the transaction recommended, or one substantially like it, is carried out. Failure to disclose should be an offence. Given the way remuneration is structured for such policies, it may not be a straightforward matter in all cases to provide information on the amount of contributions that are actually invested. This kind of difficulty is not enough to outweigh the benefits of full disclosure.[55] In fact, it underlines the importance of the recommendation.

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50. s 849(2)(d).
51. See para 5.14. Prospectuses for unit trusts usually disclose the entry fee and specify that up to a stated percentage of that entry fee can be paid to the intermediary. The actual percentage to be paid is determined at the discretion of the operator. Alternatively, an adviser may come to an agreement with a client that the client will pay the adviser a fee for service instead of the adviser receiving the commission. In this case, the adviser notifies the manager that the commission is to be rebated and the manager issues additional units to the investor to the value of the rebated commission.
52. Most advisers now provide a summary table showing the investment product, amount invested in dollar terms, the establishment fee in percentages or dollars, the brokerage receivable, both initial (amount or percentage) and on-going (% a year): K Breakspear 'The right to know an adviser' 1992 (June) *Financial Planning*.
53. Proposal 10.7
54. eg Treasury *Submission* 24 December 1992; TCA *Submission* 17 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; Mercantile Mutual Holdings Ltd *Submission* 16 December 1992; MLC Investments Ltd *Submission* 17 December 1992; FPAA *Submission* 7 December 1992; IFA *Submission* 1 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992.
55. The TPC Report commented on this matter: 'Should the ISC and the life offices, in seeking to implement [the recommendations about disclosure of commissions], be unable to overcome the practical difficulties that may be involved in defining and measuring intermediary remuneration and benefits on a consistent basis, consideration should be given to restricting intermediary remuneration and benefits to specified forms which are capable of clear definition and measurement': 1-16.

Ultimately, it should be for the investor to judge whether the remuneration arrangements of the intermediary are fair and reasonable, the extent to which they affect the returns on the investment and the extent to which they may have influenced the intermediary's recommendation.

Information about themselves

13.20 DP 53 proposed that intermediaries should provide information about themselves, for example, about the services they can offer and the type of licence they have.[56] In light of the above recommendations, the Review no longer considers this necessary.

Issues relating to life insurance products

Equivalent controls on the marketing of similar products

13.21 Even though investment linked life policies are not regulated under the Corporations Law, they compete with investments that are regulated by that law. They should be marketed in a similar way, with similar restrictions. Investors will then be better able to compare products and make an informed choice.

Insurance (Agents and Brokers) Act

13.22 Life insurance company agents are subject to the supervision of the life insurance company with whom they have entered an agency arrangement. Under the *Insurance (Agents and Brokers) Act 1984* (Cth), life companies are responsible for the actions and behaviour of their agents. The Act does not prescribe minimum standards for selection or supervision of agents.[57] Some life companies operate unit trusts, usually through a subsidiary, as well as offer life insurance policies. Those unit trusts are often marketed through a life company's life agents, but in the agents' capacity as representatives of the life company's subsidiary, which, under the current law, must have a dealers licence to operate the trust. In respect of the sale of interests in the unit trust, the agent will be regulated by the Corporations Law. An intermediary acting for a life company can, therefore, be regulated by two laws, depending on which product he or she is selling at a particular time. Investors are entitled to assume that all intermediaries selling products that serve the same function are regulated similarly, even if the organisations offering the products are regulated by different regulators. This is particularly so in respect of disclosure of commissions and other benefits.

56. Proposal 10.6.
57. In ALRC 59 the Review recommended that the *Insurance (Agents and Brokers) Act 1984* (Cth) s 10 should be amended to provide that an insurer must not enter into an agreement under which the insurance intermediary is authorised to offer superannuation unless satisfied that the intermediary is of good fame and character, will be able to act honestly, has adequate educational qualifications and expertise and is not bankrupt: recommendation 8.14. This recommendation was designed to encourage life companies to impose on their agents similar standards to those imposed on licensed dealers and investment advisers.

Requirements for life agents

13.23 Life agents who sell interests in collective investment schemes run by their principals will be required under the Corporations Law to disclose to the client details of

- commissions, fees and other benefits or advantages the agent will receive on account of making the recommendation[58]
- any other pecuniary or other interest that the agent has that may reasonably be expected to be capable of influencing the recommendation.[59]

Under earlier recommendations in this chapter, agents in these circumstances will also have to disclose how much of the client's money will actually be invested and how much will be taken as fees and other charges. A detailed breakdown of these fees and charges will have to be given.[60] Those agents will also be subject to the Review's recommendations requiring recommendations to be in writing,[61] obliging intermediaries to inquire about, and investigate, a client's investment objectives, financial situation and needs[62] and restricting intermediaries from holding themselves out as independent if he or she is in a position to receive a commission.[63] These restrictions do not apply to life agents selling investment linked products.[64] The Review noted earlier in this report that its recommendation not to include investment linked life insurance policies within the collective investment schemes governed by the Corporations Law depended on a similar regulatory framework being imposed on those products.[65] That framework includes the regulation of the sellers of these products. The Review **recommends**, accordingly, that the *Life Insurance Act 1945* (Cth) should be amended to impose on persons selling investment linked life policies requirements that reflect the recommendations made in this chapter about written recommendations,[66] making inquiries of clients, disclosure of commissions, fees and charges and the amount of money actually invested on behalf of the investor and intermediaries holding themselves out as independent. For example, there should be a separate legal obligation imposed on life insurance agents to give the same disclosures as to commissions, fees, benefits and interests as the Corporations Law imposes on persons who sell securities. This is consistent with the TPC recommendation in its recent report that all life insurance intermediaries should have to disclose to

58. s 849(2)(c).
59. s 849(2)(d).
60. See para 13.19.
61. See para 13.11.
62. See para 13.10.
63. See para 13.16.
64. There is at present no legal obligation on life agents to make similar disclosures in connection with the sale of life insurance policies, in particular, investment linked life insurance policies, although ISC Circulars encourage such disclosure. It is arguable that the insurer's obligation to act towards the client with the utmost good faith in all matters concerning the contract, which extends to pre contractual negotiations, would require the insurer (rather than the agent) to inform the client fully of these matters. Nevertheless, the Review considers that this should be made explicit in the law as an obligation imposed directly on the agent, who deals with the client.
65. See para 3.15.
66. The TPC Report recommended similarly: see para 13.11.

consumers, before the proposal form is signed, the amounts of commission and other benefits payable by the supplier of the recommended products as a result of the sale of the product.[67]

Hawking investments

13.24 Securities, including interests in collective investment schemes, cannot be sold door to door.[68] This restriction applies to securities sold by life agents as authorised representatives of licensed securities dealers. The sale of life policies, on the other hand, is not subject to such a prohibition. It has been suggested that the ability to hawk life products is detrimental to investors and that it provides insurance companies with a competitive advantage (in respect of some of their policies) over collective investment schemes. This raises the issue whether investment linked life policies should be subject to a prohibition on hawking. The life insurance industry's view is that the 14 day free look period that applies to life policies[69] provides as much protection as, if not more than, the prohibition against hawking. DP 53, which proposed that investment linked life products be regulated under the Corporations Law, asked whether life agents should be exempted from the prohibition against hawking securities on the basis that only some of the products they sell would be subject to this prohibition and that it may be difficult, as a practical matter, to operate under two sets of rules.[70] Submissions were divided on this issue. Some considered that the ban on hawking should apply to the sale of any investment linked policies.[71] Some considered that possible high pressure selling techniques, even with the 14 day cooling off period, might not give consumers enough time to consider their investment.[72] Others considered that hawking of life products should continue to be allowed. They said that the legislation already provides adequate protection.[73] The latter approach assumes that the level of disclosure required to be made by life offices to potential policyholders will be increased to a standard comparable to that required under the Corporations Law. As this report does not recommend that investment linked insurance products should be regulated under the Corporations Law, the issue is whether a prohibition on hawking should be introduced into the life insurance legislation applying to investment linked products. The Review has concluded that the improved disclosure requirements for life insurance products which the Review recommends be introduced into the LIA,[74] combined with the fact that life offices are responsible for the actions of their agents, will provide adequate protection for investors in life policies and ample opportunity for the ISC to take action against

67. TPC Report, recommendation 1(c).
68. The Corporations Law prohibits a person from going from place to place offering securities of a corporation for subscription or purchase: s 1078. 'Securities of a corporation' includes prescribed interests made available by a body corporate: s 92(2)(c).
69. See *Insurance Contracts Act 1984* (Cth) s 64.
70. Issue 10A.
71. eg National Information Centre on Retirement Investments *Submission* 24 November 1992; St George Funds Manager Limited *Submission* 18 December 1992.
72. FPAA *Submission* 7 December 1992.
73. National Mutual *Submission* 3 December 1992; AMP Society *Submission* 30 November 1992. They noted that this is also the case in the UK and the US.
74. See para 13.23.

life companies in respect of agents who abuse their position. Subject to these changes being implemented, the Review does not recommend any change to the present law in respect of hawking.

Licensing life agents

13.25 ***Industry proposal.*** Life agents are not licensed under the present law. The life company for whom they act is fully responsible for what they do.[75] Life agents who are authorised to sell interests in a collective investment scheme operated by a life company, or its subsidiary, must be authorised as representatives of the company under the Corporations Law.[76] However they are not separately licensed. The Review understands that the insurance industry favours the introduction of a system of licensing agents. The proposal, which has not been finalised, involves agents being licensed by a separate licensing board in accordance with stipulated minimum standards of education and training, a code of conduct and a procedure to ensure compliance with the code of conduct. Penalties would be provided for breaches of rules or prohibited conduct by agents, including fines, suspension and cancellation.[77] The TPC recommended in its report that any proposal for licensing of agents be submitted to it for assessment under the authorisation procedure of the *Trade Practices Act 1974* (Cth) (for restrictive trade practices).[78]

13.26 ***ALRC 16.*** In its report *Insurance Agents and Brokers* (ALRC 16, 1980) the ALRC considered whether life agents should be licensed. It had been suggested that licensing would be a way to deal with the problems of replacement of life policies (twisting) and misleading comparisons of policies and investments. The ALRC concluded that licensing was not a necessary or appropriate means to that end.[79]

13.27 ***Review's view.*** The Review is not convinced that the benefits, if any, of licensing life agents would outweigh the costs. Rather, life companies should be fully aware of their responsibilities in respect of their agents. Licensing agents could, in fact, have the reverse effect. Focusing on agents could detract from the life company's responsibility. Life companies are in the best position to monitor the behaviour and competence of their agents and responsibility for the acts of their agents should provide incentive to supervise their agents closely. The Review **recommends** that no system for licensing life agents be introduced.

75. *Insurance (Agents and Brokers) Act 1984* (Cth) s 11.
76. Corporations Law s 806, 807.
77. See TPC Report 8-13 for details of the industry's proposal.
78. Recommendation 6.
79. Para 143. The ALRC also considered the issue of licensing in its report on customs and excise. It concluded that licensing customs agents was not justified — any controls could just as effectively be imposed by the criminal law: see ALRC 60 *Customs and excise* Sydney 1992 vol 2, ch 8.

14. The regulator

Introduction

14.1 The regulator of collective investments schemes should be the Australian Securities Commission (ASC). This chapter considers the information gathering and enforcement powers that the ASC will need for this role. It first outlines the surveillance and investigative powers that should be available to the ASC. It then discusses criminal enforcement and civil preservative and recovery actions by the ASC. It concludes with proposals for suitable administrative powers for the ASC, including enforceable undertakings, calling or attending meetings of investors, revoking licences and issuing stop orders.

Single external regulator

Proposal and submissions

14.2 DP 53 argued the need for a single national regulator of all collective investment schemes including investment linked policies of life insurance companies and friendly societies to ensure consistency of regulation across different markets and to prevent operators choosing the regulatory regime most advantageous to themselves.[1] Submissions supported the proposal.[2] Some submissions, however, argued that investment-linked life policies should continue to be regulated solely by the ISC to prevent duplication of regulation and to take advantage of the expertise that a specialist regulator can provide.[3] The Review acknowledges that consistency in regulation of different products does not necessarily require them to be subject to the same regulator. It also recommends that life insurance products and investment linked policies of friendly societies should continue to be regulated by their own regulators, subject to their regulation having at least comparable disclosure and other protections for investors.[4]

Recommendation

14.3 The Review **recommends** that collective investments schemes as defined in chapter 3 should be regulated by the ASC as part of the national corporations scheme laws, and thus subject to the same Federal-State arrangements that apply to other components of those laws. The ASC should be given adequate resources, particularly to evaluate and monitor the compliance measures of collective investment schemes. As a consequence of the recommendation that life insurance products should continue to be regulated separately, the current division of responsibilities between the ASC and the ISC will not be disturbed. The Review is concerned, however, to ensure as much consistency as possible in the treatment of

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1. Proposal 11.1.
2. eg IFA *Submission* 1 December 1992; MLC Investments Ltd *Submission* 17 December 1992; ASCPA & ICAA *Submission* 15 February 1993; Attorney-General's Department, Business Law Division *Submission* 21 December 1992.
3. See for instance Treasury *Submission* 24 December 1992.
4. See para 3.15, 3.16.

functionally similar investment products by the different regulators. The Council of Financial Supervisors (comprising the RBA, the AFIC, the ASC and the ISC) is the appropriate body to co-ordinate and ensure consistency of regulation of investment products.

Self regulation

14.4 IP 10 asked whether there is a role for industry self regulatory organisations (ISROs). The majority of submissions on this issue favoured regulation being carried out by a government agency.[5] DP 53 noted concerns expressed in the UK, where the financial system involves comprehensive use of ISROs, about the level of industry self-regulation and the role and effectiveness of ISROs.[6] The Review **recommends** that the Commonwealth should retain primary responsibility for regulating the collective investments industry. No segment of the market should be substantially regulated by the industry itself.

The regulators' existing powers

ASC

14.5 The ASC has broad investigative and other information gathering powers which it may employ in relation to any person or structure regulated under the Corporations Law, including prescribed interest schemes.[7] They include powers to inspect certain books,[8] to require a securities dealer to provide specific information and, if directed, have that information audited,[9] to require persons to give assistance to the ASC and to appear for examination,[10] to require the production of books,[11] to require the disclosure of information relating to the acquisition or disposal of securities[12] and, where appropriate, to seize documents under a search warrant.[13] The national scheme laws also confer on the ASC a range of enforcement powers applicable to prescribed interest schemes. These include civil preservative or recovery actions, the instigation of criminal proceedings and various administrative remedies including powers to

- revoke approval of a prescribed interest trust deed or of a trustee[14]
- refuse to register a prospectus[15]
- issue a stop order on the issue of securities[16]

5. eg Law Council of Australia *Submission* 21 February 1992; RW Arnold *Submission* 31 September 1991.
6. eg House of Commons Social Security Committee (UK) *Second Report: The Operation of Pension Funds* March 1992 para 243-244.
7. These are conferred by the ASC Act Pt 3.
8. ASC Act s 29.
9. Corporations Law s 788.
10. ASC Act s 19.
11. ASC Act s 30-33.
12. ASC Act s 41.
13. ASC Act s 35, 36; *Crimes Act 1914* (Cth) s 10.
14. Corporations Law s 1067(5).
15. Corporations Law s 1020A(2).
16. Corporations Law s 1033.

- revoke a fund manager's dealers licence[17]
- suspend a dealers licence[18]
- issue a licensee banning order.[19]

In some instances the ASC must provide the opportunity for a hearing prior to the exercise of its administrative powers.[20]

ISC

14.6 The ISC regulates superannuation schemes and the activities of insurance companies. In regard to life insurance companies the ISC has power to

- cancel a company's licence to act as a life insurance company[21]
- require the provision of information[22]
- require the production of books and other documents[23]
- gain access to a company's premises to search for documents and to inspect and copy them[24]
- undertake an investigation of a company[25]
- obtain information pursuant to an investigation of a company[26]
- apply to the court for an order to place a company or part of the business of a company under judicial management[27]
- apply to the court for an order that a company be wound up[28]
- transfer any or all of the business of a company to another life insurance company.[29]

Information gathering by the regulator

Application of existing powers

14.7 To promote investor confidence and provide adequate investor protection, the regulator must have effective information gathering powers. It must be able to monitor compliance with the laws governing collective investment schemes by conducting surveillance programs, requiring the production of documents and disclosure of the whereabouts of information not supplied, examining persons capable of providing relevant information and, ultimately, gaining access to premises where documents may be located. Investigative powers must be carefully

17. Corporations Law s 824-826
18. Corporations Law s 827.
19. Corporations Law s 828.
20. Corporations Law s 837, 1033(3).
21. LIA s 23A.
22. LIA s 54.
23. LIA s 54A.
24. LIA s 54B.
25. LIA s 55.
26. LIA s 56.
27. LIA s 59(1)(a).
28. LIA s 59(1)(b).
29. LIA s 65, 73-6.

drafted to ensure a balance between powers needed for effective enforcement by the regulator and the protection of personal rights. The Review **recommends** that, in regulating collective investment schemes, the ASC should have available all its existing information gathering powers under the Corporations Law and the *Australian Securities Commission Act 1989* (Cth) (ASC Act). It should also have additional powers, some of which are presently possessed by the ISC but not by the ASC.

Information gathering powers

14.8 ***Introduction.*** The ASC may become aware in a number of ways of a possible breach of the law. Documents lodged with it under statutory reporting obligations, including auditors' reports, may give rise to some issue that requires investigation. It may receive a complaint from an investor in a collective investment scheme or obtain information in the course of its surveillance program. It requires comprehensive information gathering powers to ensure that it can adequately and effectively respond to instances of suspected breach.

14.9 ***Enhanced surveillance powers.*** The ASC should play a strong and active role in the regulation of collective investment schemes. This can be achieved through a concerted program of periodic and continuing surveillance. The ASC currently undertakes a surveillance program for licensees, including field inspections to monitor compliance with licence conditions.[30] Where necessary, the Commission can require the production of documents and explanations as to their contents.[31] A system of random audits is also used by the Australian Taxation Office to enforce compliance with tax legislation. DP 53 considered that a vigorous surveillance program by the regulator would significantly enhance the level of compliance by scheme operators with the law and schemes' constitutions. Submissions generally supported this.[32] The credibility of such a program may, however, be severely damaged if sufficient resources are not provided. The ASC should be given adequate funds to enable it to carry out a thorough surveillance program on a continuing basis. An ASC surveillance program for collective investments should include a review of the quality and functioning of a scheme's compliance measures, the means of ensuring correct identification of scheme assets, and adherence to the terms of the scheme and any issued prospectuses. Where appropriate, the ASC could impose additional terms and conditions on the licence,[33] either after giving the scheme operator an opportunity to be heard[34] or having the scheme operator enter into an enforceable undertaking.[35] The Review **recommends** that, to enhance its existing surveillance powers, the ASC should have further powers, exercisable whether or not a contravention is suspected, to:

30. ASC Act s 28(b).
31. Corporations Law s 788; ASC Act 37(9). However, except by initiating a formal investigation, the ASC cannot otherwise compel persons to answer questions.
32. eg MLC Investments Ltd *Submission* 17 December 1992; TCA *Submission* 17 December 1992.
33. See Corporations Law s 786.
34. See Corporations Law s 837(1)(b), (c).
35. See para 14.24.

- gain access to, and within, premises to search for and examine relevant books[36]
- bring devices upon premises to assist in such search or examination
- check and operate computers or other devices already upon the premises to obtain relevant information
- secure relevant books found during a surveillance visit
- require persons to assist its surveillance audit.

14.10 ***Production and explanation of documents held overseas.*** The ASC Act gives the ASC powers to require the production of books, to inspect, copy or retain them and to require an explanation of their contents.[37] These powers may be exercised whether or not the ASC has any suspicion of a breach of the law.[38] Powers of this nature are essential to the supervision of the collective investments industry. The ASC should not be hindered in exercising its lawful powers to obtain books. A problem arises where relevant books of persons within Australia are held on their behalf by a party outside the jurisdiction, for instance by an overseas bank. The Review **recommends** that the ASC should have an additional power to require a person within Australia to authorise the Commission to obtain documents or any other record of information directly from overseas parties.

14.11 *Search warrants.* The ASC, through the Australian Federal Police, has power under both the ASC Act[39] and the *Crimes Act 1914* (Cth)[40] to seek the issue and execution of search warrants. Exercise of this power may be the only means of ensuring the security of documents. Statutory prerequisites to the use of search warrants and the role of the courts in ensuring their proper execution provide suitable and adequate protections against possible abuse. The Review **recommends** that the existing search warrant provisions should be amended to permit warrants to be obtained by facsimile and telephone if it is impractical to apply for a warrant in person. This would expedite their issue and execution, which is particularly necessary where urgent action is required to secure documents. The Review also **recommends** that a person executing a warrant should be permitted to leave the premises temporarily without the warrant thereby being discharged.

14.12 *Examination of persons.* To ensure effective investigations, the ASC must have appropriate powers to require persons to answer questions under compulsion. The ASC may act where it suspects or believes, on reasonable grounds, that a

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36. The ISC has power of access to the premises of life insurance companies to search for and take possession of documents: LIA s 54B. The ATO also has powers to enter premises to inspect and take extracts from or copies of documents: ITAA s 263. The ASC has no such powers in relation to operators of prescribed interest schemes and, short of entering under a search warrant, must rely on common law licensee principles to enter premises. At common law persons have an implied licence to enter private land for lawful purposes. This right of entry and inquiry may be withdrawn by an unequivocal direction from the owner or occupier to leave the premises. Failure to leave, within a reasonable time, constitutes a trespass.
37. ASC Act s 29-33; 37(9).
38. ASC Act s 28, 29. The ASC Act Pt 3 Div 3 powers may be used against any relevant person, including an external auditor, whether or not that person is suspected of having committed a contravention.
39. s 35, 36.
40. s 10.

person can give information relevant to an investigation.[41] DP 53 proposed that the regulator of collective investments schemes should have the same power for collective investment schemes.[42] Submissions generally supported this proposal.[43] The ASC's examination powers will be available in the regulation of collective investment schemes. The ASC has no statutory power to restrain an examinee from discussing his or her evidence with another person,[44] although it may have implied powers to make limited non-disclosure orders.[45] The issue of restraining powers should be considered in a review of the ASC's investigation powers, rather than in the limited context of collective investments.

14.13 ***Power to arrest.*** The ASC may apply to a court for the arrest of a person who is either absconding from Australia, or improperly dealing with books, to avoid his or her obligations in connection with the winding up of a company.[46] The Review **recommends** that the ASC should have similar powers where a collective investment scheme is being wound up.

14.14 ***Protection of examinees.*** Investigative and other information gathering powers require persons to provide oral or written information under direction. The Parliament has recognised the need for statutory coercive powers of this nature to accommodate longstanding common law privilege and 'right to silence' principles. For instance, legal practitioners at ASC examinations may lawfully claim legal professional privilege,[47] and other examinees are granted an evidential immunity regarding self-incriminating or otherwise legally privileged information.[48] DP 53 noted that these privileges were not absolute and that any evidential immunity consequent upon giving information may be restricted.[49] It proposed that the approach adopted in the ASC Act, which currently applies to investigations concerning prescribed interest schemes, be applied to collective investments. Submissions generally supported the proposal.[50] One submission agreed in principle that there should be consistency under the national scheme laws

41. ASC Act s 19.
42. Proposal 11.3.
43. eg Macquarie Investment Management Ltd *Submission* 24 November 1992; MLC Investments Ltd *Submission* 17 December 1992.
44. Contrast ASC Act s 55: the Commission may restrict publication of certain material given at Commission hearings under Pt 3 Div 5.
45. An ASC examination must take place in private: ASC Act s 22. The ASC, by implication, may be entitled to take all reasonable steps necessary to maintain this privacy. The ASC might, by 'non-disclosure' directions, seek to prevent or restrict the premature disclosure of evidence given at an examination, provided the directions do not go beyond what is reasonably necessary to ensure the secrecy of the examination, as would, for instance, directions prohibiting disclosure indefinitely.
46. Corporations Law s 486B.
47. ASC Act s 69. A claim of legal professional privilege at the examination is available only to legal representatives: *CAC (NSW) v Yuill* (1991) 4 ACSR 624; *ASC v Dalleagles Pty Ltd* (1992) 8 ACSR 109.
48. ASC Act s 68, 76.
49. For instance, the self-incrimination evidential immunity in the ASC Act s 68 protects only the examinee in criminal proceedings, other than for perjury, but not in any civil proceedings other than for the imposition of a civil penalty against the examinee. The evidential immunity is not available to bodies corporate: ASC Act s 68(2); Corporations Law s 1316A.
50. Macquarie Investment Management Ltd *Submission* 24 November 1992; MLC Investments Ltd *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992.

> but without wishing to be taken as saying that it regards the current state of the law on privilege and immunity as being satisfactory.[51]

The Review supports the principle of consistency regarding privileges from disclosure and evidential immunities under the national scheme laws. The privileges from disclosure, the immunities from use in evidence and the liabilities for non-compliance under the ASC Act will apply to collective investment schemes.

14.15 ***Protection of informants.*** Persons who provide information in compliance with a direction or purported direction of the ASC are protected from consequential civil liability.[52] Persons who are obliged to report certain matters to the ASC are similarly protected.[53] However, other persons who volunteer information to the ASC do not have this statutory protection but must rely on the common law.[54] The Review **recommends** that the directors and other officers of scheme operators and any other persons involved in the compliance activities of collective investment schemes should be given statutory qualified privilege in respect of any information volunteered to the ASC .

Enforcement by the regulator

Criminal prosecutions

14.16 Criminal proceedings are one of the central means of enforcing the laws regulating collective investment schemes. For schemes currently defined as prescribed interests, the ASC undertakes such proceedings in conjunction with the Director of Public Prosecutions (Cth).[55] Submissions supported the proposal in DP 53[56] that similar powers should apply in respect of collective investment schemes. The ASC will be able to institute proceedings for an offence against a collective investment scheme law in the same manner as any other charge under the Corporations Law.

Civil enforcement

14.17 DP 53 described adequate civil as well as criminal enforcement powers as essential deterrents against contraventions of the law and the scheme constitution and as means to protect the assets and lawful interests of investors. The ASC should be able to undertake a range of civil proceedings to ensure an effective enforcement strategy, including

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51. Law Council of Australia *Submission* 16 December 1992.
52. ASC Act s 92.
53. eg Corporations Law s 1289 in relation to auditors. Qualified privilege protects a person from any consequential civil liability for breach of confidentiality (express or implied), defamation or otherwise, except for any disclosure motivated by malice. See also Corporations Law s 89.
54. At common law, informants who seek to expose iniquities are generally protected from legal redress, though some doubt remains whether, and to what extent, informants must have had reasonable grounds for their belief of misconduct.
55. Corporations Law s 1315; ASC Act s 49.
56. Proposal 11.5.

- preservative actions
- civil recovery
- representative proceedings.

Preservative actions

14.18 *General powers.* Preservative actions are designed to prevent or contain loss caused by contraventions of relevant laws. The ASC should be permitted to take civil proceedings to seek to preserve scheme assets at risk from illegal activity. DP 53 proposed that the preservation powers currently available to the ASC in respect of prescribed interest schemes, including those dealing with breaches of the scheme constitution,[57] should also apply to collective investment schemes.[58] Under these powers, the ASC may, by court order, obtain

- Mareva injunctions
- statutory injunctions and related orders[59]
- asset freezing, receivership and related remedies[60]
- orders restraining dealings in accounts held by licensees[61]
- provisional liquidations.[62]

Submissions fully supported the Review's proposal. These powers will be available to the ASC in regulating collective investment schemes. The interests of investors would be further enhanced by empowering the ASC to seek two further preservative remedies:

- an order for compliance
- a court appointed temporary scheme operator.

14.19 *Order for compliance.* In some instances an apparent refusal or failure of the scheme operator to comply with the Corporations Law or the scheme constitution may be best dealt with by a direction to comply. The Review **recommends** that the court should have a compliance directions power, exercisable upon the application of the ASC, a director of the scheme operator or an investor.[63]

14.20 *Court appointed temporary scheme operator.* DP 53 proposed that, as an additional preservative remedy, the regulator should be able to apply to the court for the appointment of a person to act as a temporary scheme operator.[64] This would ensure continuity of a scheme where the scheme operator had failed to fulfil

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57. Corporations Law s 1073(1A).
58. Proposal 11.9.
59. Corporations Law s 1324.
60. Corporations Law s 1323. A court may appoint a receiver under s 1323(1)(h), but will do so only where the circumstances are serious and no lesser remedy is suitable. There is no direct power in s 1323 for the court to order who shall pay the fees of the receiver or the receiver and manager. In the context of collective investments, the court should be empowered to direct such payments from the assets of the operator, the scheme or both.
61. Corporations Law s 874-878.
62. Corporations Law s 464, 472.
63. cf Corporations Law s 777.
64. Proposal 11.10.

its obligations, or was unable or unwilling to continue as operator. It would be similar to the power of the Insurance and Superannuation Commissioner to apply for a court order to place a life insurance company under judicial management.[65] An investor in a scheme, or the scheme operator itself, should also have standing to apply to have a person appointed as a temporary scheme operator. Submissions generally supported the right to seek a court appointed scheme operator.[66] One submission argued that the investors' rights should be confined to approaching the regulator or calling a meeting to remove a scheme operator.[67] The Review considers, on balance, that individual investors should be given standing to approach the court, which could discipline vexatious or unmeritorious applicants through costs orders. Another submission questioned the need for any specific judicial management power, given that under the Corporations Law s 1323 the court may appoint a receiver or receiver and manager.[68] The Review recognises the width of the s 1323 powers, but notes the limiting prerequisites of the section, namely, that there be an ASC investigation or civil or criminal litigation on foot. There are various other instances where a temporary scheme operator may be required, for instance, where the scheme operator goes into receivership or provisional liquidation, or is otherwise unable or unwilling to continue, and a replacement scheme operator has not yet been approved. These matters are not covered by s 1323. The Review **recommends** that the court should have power, upon an application by the ASC, an investor or the scheme operator, or any of its directors, to appoint a person to act as the temporary scheme operator. A liquidator or administrator of a scheme operator or a receiver of property of a scheme operator should be required to apply immediately to the court to appoint a temporary scheme operator in respect of each of the operator's schemes. A scheme operator that is unable to pay its debts should be obliged to make a similar application. A scheme operator should not be entitled to retire until either a replacement scheme operator has been approved by investors or the court has appointed a temporary scheme operator.[69] A court appointee need not hold a scheme operators licence or be incorporated. The court order should specify the terms and conditions of the appointment, including the powers and reporting obligations of the temporary scheme operator.[70]

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65. LIA s 59(1)(a). The LIA obliges the judicial manager, as soon as possible following his or her appointment, to prepare a report to the court on the course of action which, in his or her opinion, will be most advantageous to the company's policyholders. The report may recommend a range of actions including transfer of a company's business, merger of that business with another company or the winding up of the business. The court may then make such orders as it considers appropriate in the circumstances.
66. eg Macquarie Investment Management Ltd *Submission* 24 November 1992; National Mutual *Submission* 6 November 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992; TCA *Submission* 17 December 1992; MLC Investments Ltd *Submission* 17 December 1992; FPAA *Submission* 7 December 1992.
67. St George Funds Manager Limited *Submission* 18 December 1992.
68. M Starr *Submission* 12 November 1992.
69. See para 11.15.
70. For instance, the court appointee might be required to prepare a report to the court as soon as possible, stating the course of action considered most advantageous to the interests of investors. This might include the continuation, merging or winding up of the scheme. The court could then make such further orders as it considers appropriate in the circumstances.

Civil recovery and representative proceedings

14.21 ***Introduction.*** The ASC currently may institute a range of civil recovery proceedings against persons involved in prescribed interest schemes, including

- orders for restitution[71]
- oppression remedies[72]
- liquidations[73]
- insider trading orders[74]
- representative public interest actions.[75]

To better regulate collective investment schemes, the ASC should also have powers to

- undertake representative actions against scheme operators
- enforce the deed or instrument constituting the scheme
- take action against hired investment managers.

14.22 ***ASC power to act on behalf of investors.*** DP 53 proposed that the ASC should be able to stand in the shoes of an investor to enforce the general law and the scheme constitution.[76] The ASC currently has this power where it is investigating possible breaches of prescribed interest scheme covenants.[77] In addition, DP 53 proposed that the ASC should be able to take proceedings against the scheme operator as the representative party under the enhanced representative procedure provided for in the *Federal Court of Australia Act 1976* (Cth) Part IVA.[78] Submissions supported the regulator having this representative power.[79] However one submission proposed that the regulator should take a representative action only at the request of a quorum of investors.[80] Another submission doubted whether

71. Corporations Law s 1325.
72. Corporations Law s 260.
73. Corporations Law s 461, 462, 464.
74. Corporations Law s 1013(6).
75. ASC Act s 50.
76. Proposal 11.11, 11.14.
77. Corporations Law s 1073(1A) deems any breach of a covenant to be a contravention. The ASC may commence an investigation pursuant to ASC Act s 13 where it has reason to suspect any such contravention. The ASC Act s 50 empowers the ASC, in consequence of an investigation, to undertake civil recovery proceedings in the name of consenting investors. Consent is not required where the ASC acts in the name of a company. Where an action is taken by the ASC without the consent of particular investors, it should not prevent those persons from exercising their rights, nor impose on them any liability for costs, particularly if the action fails.
78. This would enable the regulator to recover damages on behalf of investors without the need to obtain the consent of all the investors being represented. However, if fewer than seven investors were involved, the Federal Court could order that the proceedings not continue as an enhanced representative proceeding. In that case, the regulator would still be able to act as the representative of any investor who consented.
79. eg TCA *Submission* 17 December 1992; Macquarie Investment Management Ltd *Submission* 24 November 1992.
80. IFA *Submission* 1 December 1992.

representative actions would be preferable to facilitating private enforcement.[81] The Review does not support an investor quorum requirement. It **recommends** that the ASC should be entitled to act as a representative party pursuant to the Federal Court class action rules.[82] Currently it may intervene in any civil proceeding involving a prescribed interest.[83] This power is an appropriate one for collective investments. Representative actions are not a substitute for private civil enforcement. Indeed private litigation is an additional enforcement mechanism. The ASC currently can assist private litigants by providing them with copies of relevant records of formal examinations.[84] The Review **recommends** that, in addition, the ASC should have a specific power to provide these persons with any relevant books it has in its possession, in addition to those related to an oral examination.[85]

14.23 ***Proceedings against a hired investment manager.*** A scheme operator may choose to contract out the investment function of a scheme. The operator will have the right to take proceedings in contract and tort against a hired investment manager for some breaches. Some scheme operators may find their resources insufficient to commence or continue such an action or may otherwise decline to act. The ASC could protect investors' interests by undertaking this litigation. DP 53 proposed that the regulator should have the power to litigate on behalf of the scheme operator. Most submissions supported the proposal.[86] However, one submission argued that it should remain the sole duty of the scheme operator to enforce these legal rights.[87] Another submission expressed doubts about the principle of giving the regulator power to intervene in these private arrangements.[88] A third submission expressed reservations about investors not having to consent.[89] The Review does not envisage the ASC having power to block private civil enforcement. Rather, the concern relates to a scheme operator that is unwilling or unable to act, despite an apparently good cause of action. In such circumstances

81. Law Council of Australia *Submission* 16 December 1992 doubted that 'simply vesting investors' rights in the regulator is a strategy preferable to facilitating the enforcement by the investors of their own rights, either by diminishing the cost barrier or by promoting more efficient means of access on a representative or other basis to the courts'.
82. Pursuant to FCR O 73 and its powers under ASC Act s 50, the ASC could seek to consolidate proceedings against various parties (FCR O 29 r 5) or join separate causes of action (FCR O 6).
83. Corporations Law s 1330. Refer ASC Policy Statement 4.
84. See ASC Act s 25, 26.
85. ASC Act s 25 permits the ASC to provide private litigants with books 'related' to a record of examination. The ASC has given a wide interpretation to the term 'related books' as being 'not only documents formally identified and incorporated in the record of examination, but also documents referred to directly or indirectly in the record and which would assist the comprehension of the records': ASC Policy Statement 17 para 10. However even on this wide interpretation, a nexus between the record of the oral examination and the books is required. The ASC may permit private litigants to inspect other books held by it pursuant to ASC Act s 37(7). These books may be used for the purpose of any proceedings: ASC Act s 37(4). The ASC may also agree, pursuant to the Corporations Law s 1330, but subject to ASC Act s 127, to provide information to or exchange information with another litigant in any case in which it has intervened: ASC Policy Statement 4. The Review's recommendation is intended to resolve any doubt over the ambit of these powers.
86. eg Credit Union Services Corporation (Australia) Ltd *Submission* 27 November 1992; FPAA *Submission* 7 December 1992; ISC *Submission* 12 November 1992; St George Funds Manager Limited *Submission* 18 December 1992.
87. Macquarie Investment Management Ltd *Submission* 24 November 1992.
88. IFA *Submission* 1 December 1992.
89. TCA *Submission* 17 December 1992.

the ASC could act to protect scheme assets by enforcing those rights on behalf of the scheme operator. To permit the regulator to act only with the consent of the operator or the investors would limit the effectiveness of this remedy. The Review supports the ASC being able to undertake any proceeding for relief against an investment manager on behalf of the scheme operator, with or without its consent.[90] Relief includes damages and compensation, recoverable as scheme assets. Any such proceedings will not relieve the scheme operator of any liability for breach of duty in failing to act.

Administrative remedies

Enforceable undertakings

14.24 The *Trade Practices Act 1974* (Cth) (TPA) was recently amended to provide that the Trade Practices Commission (TPC) may accept undertakings from companies in connection with any matter in relation to which it has a power or function.[91] The amendment gives legislative recognition to a practice that had been adopted by the TPC in a number of its investigations. It is expected that, for the most part, an undertaking will be sought by the TPC when, after an investigation of a suspected contravention of the TPA, the TPC judges that an undertaking will better serve to promote compliance with the TPA than legal proceedings in respect of the contravention. An undertaking might also be used to settle such proceedings. Under the TPA, the undertakings will be 'enforceable' in their own right. The Federal Court may, if an undertaking is breached, make appropriate orders. These could include orders directing the other party to the undertaking

- to comply with it
- to pay to the Commonwealth any financial benefit that it has obtained directly or indirectly and that is reasonably attributable to the breach
- to pay compensation to anyone who has suffered loss because of the breach.[92]

The ALRC will be reviewing the effectiveness, and other aspects of these undertakings in the course of its work on enforcement of the TPA.[93] However, it is clear that the facility to accept undertakings of this type is a valuable and useful addition to the enforcement options available to regulators, particularly in commercial or business areas of regulation. The Review **recommends** that the ASC should have such a power. There should be no compulsion to enter into an undertaking; to emphasise that, and to guard against the possibility that the use of undertakings may be oppressive, the Law should expressly provide that the obligations imposed on a scheme operator by such an undertaking should be of no effect so far as they are inconsistent with a national scheme law. In other respects, the TPA provisions should be adopted, and any modifications resulting from the ALRC's review, when completed, should be incorporated.

90. ASC Act s 50.
91. See *Trade Practices Legislation Amendment Act 1992* (Cth) s 13 which adds s 87B to the TPA.
92. TPA s 87B(4).
93. Referred to the ALRC by the federal Attorney-General on 17 December 1992.

Calling meetings

14.25 ***Proposal and submissions.*** Presently the ASC has no power unilaterally to call a meeting of investors in a prescribed interest scheme.[94] DP 53 proposed that it should have such a power in respect of collective investment schemes. It may facilitate rapid action to resolve matters without resort to any, or further, civil litigation. It would be particularly useful where several schemes with the one operator were experiencing similar problems. Submissions favoured the ASC having this power, although some expressed reservations about the width of the proposed power to propose resolutions.[95] One submission argued that this power should be available only where the ASC has commenced a formal investigation and the scheme operator has refused its request to convene a meeting.[96] Another submission doubted the practical benefit of the power, as the ASC may not be in a position to identify issues, formulate proposals, and prescribe the information to be sent to investors without prior use of its investigation powers.[97]

14.26 ***Recommendation.*** The Review recognises that the ASC would call a meeting only where it held sufficient information to warrant it and where it believed a meeting would be beneficial to investors. The ASC should be able to propose resolutions only on matters on which investors can lawfully vote.[98] An ASC power, in appropriate circumstances, to so act may assist investors to control their own schemes, especially where various courses of action are possible, for example, to continue with the scheme, wind it up or replace the scheme operator. The ASC should ensure that investors are properly informed and that the meeting is properly conducted. The Review **recommends** that the ASC should have power to call investors' meetings and propose resolutions.

Attending meetings

14.27 The ASC may wish to participate in meetings called by the scheme operator or requisitioned by investors. The ASC's presence may considerably assist investors in their deliberations. The Review therefore **recommends** that the ASC should be able to attend and speak at any meeting of the investors in a collective investment scheme.

Revocation of a scheme operator's licence

14.28 ***Introduction.*** The Review has recommended that a scheme operator must be licensed.[99] An operators licence will be subject to such conditions or restrictions as are prescribed or imposed by the ASC.[100] Licensed dealers are required to notify

94. The ASC could unilaterally call a meeting only by acquiring sufficient units in a prescribed interest scheme to requisition the meeting.
95. TCA *Submission* 17 December 1992.
96. IFA *Submission* 1 December 1992.
97. Law Council of Australia *Submission* 16 December 1992.
98. See para 11.13-11.23.
99. See para 10.35.
100. Corporations Law s 786. The ASC cannot impose further conditions on a licence, or vary the conditions of a licence, without first providing the opportunity for a hearing: Corporations Law s 837(1)(b),(c).

the ASC promptly of any breach of a licence condition.[101] The Review **recommends** that the same obligation should apply to holders of a scheme operators licence. The ASC may, where appropriate, suspend or revoke a licence or issue a banning order.[102] These administrative powers, other than licence suspension,[103] are appropriate complements to civil preservation and recovery remedies.

14.29 ***Revoking a licence without providing an opportunity for a hearing.*** The present licensing regime empowers the ASC to revoke a dealers licence, without providing an opportunity for a hearing, in limited circumstances.[104] The ASC should have comparable powers in respect of scheme operators licences. The Review **recommends** that the ASC should have power, without a hearing, to revoke the licence of a scheme operator if it

- becomes an externally administered body corporate[105]
- ceases to carry on business
- requests the ASC to revoke its licence.

Each of these matters is an objectively ascertainable fact and a hearing would serve no useful purpose.

14.30 ***Revoking a licence after providing an opportunity for a hearing.*** In certain circumstances, the ASC may revoke a licence and make a banning order against a licensee or an unlicensed person acting as a representative of a licensee, subject to providing an opportunity for a hearing.[106] DP 53 proposed that the regulator should have power to revoke a scheme operators licence outright, or in respect of one or more schemes, without providing an opportunity for a hearing, if, in its opinion

- there is a risk of non-compliance by the scheme operator with the relevant law
- there has been or is likely to be a breach of any of the conditions or restrictions of the operator's licence
- the scheme operator is unable, or has failed, to fulfil its duties.[107]

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101. Corporations Law s 787.
102. Corporations Law Pt 7.3 Div 5.
103. Licence suspension powers are not appropriate for scheme operators given the need for a scheme to have an operator at all times during its life. Where a scheme operator's licence is revoked, a temporary or replacement scheme operator must be appointed to ensure continuity. By contrast a securities dealer could be suspended from conducting that business for a limited period because there is no need to ensure continuity.
104. Corporations Law s 825.
105. Defined in Corporations Law s 9.
106. Corporations Law s 826-829, 837.
107. Proposal 11.15. In ALRC 59 the Review recommended that the regulator of superannuation schemes should have the power, without a hearing, to suspend or remove a superannuation scheme operator, or a member or director of an incorporated scheme operator, having regard to the risk of non-compliance with the law or inability to perform the duties of the position: recommendation 13.12. This power was needed because no licensing regime was recommended for superannuation scheme operators.

Several submissions opposed the ASC having power to revoke a licence without a hearing.[108] They pointed to the possibly irreversible commercial damage that could result to an operator through loss of its licence, even temporarily. The ASC will have adequate powers under the Review's other recommendations to act quickly and decisively to preserve assets at risk, ensure the continued administration of a collective investment scheme and protect the interests of existing and potential investors. Consequently, there is no overriding public interest in denying a scheme operator an opportunity for a hearing prior to any decision by the ASC to revoke its licence outright, or in respect of one or more schemes. The Review **recommends** that the ASC should have power to revoke a scheme operators licence, outright or in respect of one or more schemes, subject to providing the opportunity for a hearing, if it is satisfied that there is a significant risk that the operator will contravene or fail to comply with the Corporations Law, so far as it relates to the scheme, in relation to a substantial matter. In determining this, the Commission shall have regard to any submission made by or on behalf of the scheme operator about the matter. In addition, the Commission may have regard to whether

- information given in connection with an application was false or misleading in a material particular
- whether what the operator is doing by way of compliance measures is adequate to detect in advance and prevent relevant contraventions in relation to the scheme
- the scheme operator is unable to fulfil, or has failed to fulfil, the duties or functions of the position under the law or under the scheme constitution
- the scheme operator has contravened the Corporations Law in relation to any scheme
- the number of non-executive directors of the scheme operator has at any time, without reasonable excuse, been less than half the total number of board members for any period exceeding 14 days
- there has been, or there is likely to be, a breach of any of the conditions or restrictions of the licence by the scheme operator
- the scheme operator has failed to maintain the necessary capital requirement for any period exceeding 14 days
- the scheme operator, or any of its directors or other executive officers, has been convicted of serious fraud
- a civil penalty has been imposed on the scheme operator or any of its directors or other executive officers.

If its licence is revoked, the former scheme operator must, without delay, surrender the relevant licence certificate to the ASC.

14.31 ***Temporary operator.*** To ensure continuity of a scheme the Review also **recommends** that on giving a notice revoking a scheme operators licence, the ASC should have to apply to the court for the appointment of a temporary scheme operator, unless an eligible replacement scheme operator has already been properly appointed or the scheme has been terminated.

108. eg IFA *Submission* 1 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.

14.32 ***Review and appeal rights.*** A scheme operator whose licence has been revoked will have a right of appeal on the merits, or in law, in the same manner as all other licensees regulated under the Corporations Law.[109] The Review also **recommends** that any written notice to a scheme operator, or any other affected person, of a decision or determination by the ASC should be required to include a statement of any rights to apply for a review by the Administrative Appeals Tribunal.

14.33 ***Record of banned scheme operators.*** The ASC is required to keep a register of disqualified company directors and officers, which may be inspected and copied by the public.[110] The Review has considered whether there should also be a public register of corporations disqualified from acting as a scheme operator.[111] Little purpose would be served by such a register. Scheme operators must be licensed and information about licensees can be obtained by search at the ASC. There is little point in maintaining a separate register in addition to this. The Review therefore does not recommend that a register of banned scheme operators be kept.

Suspension or revocation of licence of a hired investment manager

14.34 DP 53 discussed whether the regulator should have the power, with or without a hearing, to suspend the securities dealers licence of a hired investment manager if, in its opinion, this was necessary having regard to the risk of non-compliance with the relevant law, a breach or anticipated breach of any of the conditions or restrictions of the licence or the apparent inability of the investment manager to fulfil its duties and functions.[112] The Review considers that adequate powers exist under its other recommendations to protect the legitimate interests of all relevant parties, without providing the ASC with an additional power to suspend or revoke this licence without a hearing. Hired investment managers should remain subject to the same disciplinary procedures as other licensees.

Suspension or revocation of licence of an intermediary

14.35 Many investors make investment decisions on the basis of recommendations by dealers and investment advisers. The regulator has an important role in controlling the operations of these intermediaries. The ASC may revoke, without a hearing, a dealers or advisers licence if an individual holder is insolvent or is convicted of serious fraud or if a corporate holder becomes externally administered.[113] In certain circumstances the ASC may revoke a licence, subject to providing an opportunity for a hearing.[114] These circumstances include where the ASC has reason to believe that the licensee has not performed his or her duties efficiently, honestly and fairly and it has reason to believe that the licensee is not of

109. Corporations Law Pt 9.4A provides for rights of review of various decisions of the ASC, on the merits, by the Administrative Appeals Tribunal. The Federal Court has jurisdiction to review ASC decisions pursuant to the *Administrative Decisions (Judicial Review) Act* 1977 (Cth); *Corporations Act 1989* (Cth) Pt 8 Div 2A; *Corporations ([State]) Act* Pt 8 Div 3.
110. Corporations Law s 243.
111. DP 53 para 11.31.
112. Para 11.32.
113. Corporations Law s 824, 825.
114. Corporations Law s 826, 837.

good fame and character.[115] The ASC may also make a banning order to prohibit a person from acting as a representative of a dealer or investment adviser.[116] These powers will apply to collective investments intermediaries. The Review considers them sufficient.

Stop orders to prevent further issue of interests

14.36 The ASC can prevent the issue of further securities where, in its opinion, any information issued pursuant to a prospectus is false, misleading or deceptive.[117] This stop order power will apply to collective investment schemes because interests in schemes are securities. Thus the ASC will have power to prevent the issue of further units or interests in a collective investment scheme, either to new or existing investors. This power will complement the other powers available to the ASC to protect the interests of investors and potential investors.

115. Corporations Law s 826.
116. Corporations Law s 829.
117. Corporations Law s 1033.

15. Offences

Introduction

15.1 This report recommends that certain acts and omissions by the operators of collective investment schemes and, in some cases, by other persons, should constitute contraventions of the Corporations Law. This chapter deals with the consequences of such contraventions. It discusses which contraventions ought to be punishable as offences and whether the recently enacted civil penalty regime[1] ought to be applied to any of these contraventions. The chapter also covers issues related to the construction of those offences and a number of problems flowing from the fact that scheme operators will be companies.

Issues about criminal offences

Constructing offences

15.2 If contraventions of the Law are to be made criminal, careful consideration needs to be given to the construction of the relevant offences. In particular, the mental and 'fault' elements of the offence will have to be carefully considered.[2] The Review **recommends** that the fault element of each contravention should be expressly stated in the Corporations Law. The legislation in Volume 2, giving effect to the Review's recommendations, does this in one of two ways:

- for contraventions that should not require a fault element — by specifying in the provision defining the contravention that fault is not an element of the contravention
- in other cases — by stating precisely the fault element required.

Where a provision does not expressly address the fault element, the normal rule requiring *mens rea* will apply.

Fault element for particular contraventions

15.3 ***Some contraventions have no fault element.*** Determining what fault element is required for a particular statutory offence is often a difficult matter. These problems were identified the ALRC's report *Customs and excise* (ALRC 60, 1992).[3] The draft legislation in Volume 2 has been prepared on the basis that the general principle that, in the absence of an evident intention to the contrary, a

1. Corporations Law Pt 9.4B.
2. A fault element is present when the prosecution or applicant must prove that what the defendant did not accord with some standard, say a standard of reasonable care or recklessness. The mental element is present when it is necessary to prove that the defendant had a particular belief, suspicion or other state of mind in relation to the matter. For mental or fault elements for offences committed by companies, see para 15.17, which makes recommendations about the circumstances in which the acts and states of mind of a corporation's servants and agents can be attributed to the corporation.
3. ALRC 60 vol 2 para 9.3-9.5.

statute that creates an offence is to be read as requiring the offence to include a fault element will apply. However, the Review **recommends** that, for a number of these contraventions, there should be no fault element. These include, among others:

- failure to use the scheme's registration number
- acting as scheme operator without being licensed or without the scheme being registered
- failure to notify the ASC of licence contraventions
- failure to return a revoked licence
- failure to observe the buy back or redemption restrictions
- failure to observe the requirements about keeping registers
- failure to maintain the minimum net value prescribed
- failure to observe the prescribed borrowing limits.

In these cases, the draft legislation specifies that the defendant's state of mind, intentions and beliefs and the degree of care, if any, that the defendant exercised, do not need to be proved by the prosecution and cannot be relied on by way of defence. One consequence is that, for these contraventions, the rule that the defendant has a defence if it can show that it had a reasonable but mistaken belief that a state of affairs existed that, if true, would have meant that there was no contravention will not apply.[4] These 'no fault clauses' should not necessarily exclude other defences, for example, the defence discussed below that the defendant was taking reasonable measures to prevent relevant contraventions.

15.4 *Justification for 'no fault' clauses.* These departures from the normal rule requiring fault are justified on several grounds.

- ***Regulatory offences.*** The offences or contraventions for which fault is excluded are in most cases largely regulatory and are not intended to involve any real criminality.

- ***Professional corporate entities.*** The defendants will in all instances be corporations who will be professional operators.

- ***Link with compliance measures.*** In almost all cases where fault is excluded, a defence is included that the defendant was taking all reasonable measures to prevent contraventions of the relevant kind.[5] Exclusion of fault, together with such a defence, will encourage scheme operators to devote adequate resources to compliance.

Form of the compliance measures defence

15.5 The Review **recommends** that the defence just mentioned, that the defendant was taking all reasonable measures to prevent relevant contraventions, should apply in most instances. Two points need to be made.

4. See *Proudman v Dayman* (1941) 67 CLR 536.
5. See para 10.40.

- The defence is independent of the conditions of a licence to which the operator has agreed, specifying particular compliance measures. The fact that the licence has been issued should not be relevant to the question whether what the defendant was doing by way of compliance measures was reasonable for the purposes of this defence.[6]

- If compliance measures are working effectively, they will bring to attention likely contraventions. In the light of this, if the executive officers of the defendant company have reasonable grounds to suspect that a contravention would occur, the corporation should not be able to rely on the defence.

Penalties

15.6 ***Penalty levels not recommended.*** The Review has not suggested the appropriate level of penalty in respect of any of the offences recommended. This should be decided in the light of Commonwealth policy on fixing penalties generally and the levels of penalty prescribed for other contraventions of the Corporations Law.

15.7 ***Administrative penalties.*** The Corporations Law s 1313 provides for a penalty notice system under which the ASC can issue a penalty notice alleging a contravention and specifying a penalty fixed by the Corporations Law for that offence. If the penalty fixed in the notice is paid, the matter is regarded as closed and further proceedings cannot be taken in respect of the alleged contravention. The ALRC considered such schemes in two recent reports[7] and recommended that they continue to be available in appropriate cases. The Review **recommends** that the penalty notice provision be available for appropriate offences recommended in this report.

Civil penalties for contraventions

Present law

15.8 Recent amendments to the Corporations Law have established a 'civil penalty' regime which applies to directors of companies.[8] Under the regime, a director who

- breaches the statutory fiduciary duties imposed on directors by s 232(2), (4), (5), or (6)
- breaches the rules governing related party transactions (s 243ZE(2) or (3))
- fails to take reasonable steps to ensure that the company keeps the required accounting records and prepares appropriate financial statements (s 318(1))
- fails to prevent the company from engaging in insolvent trading (s 588G)

6. And other relevant defences within the Corporations Law, for example, s 1002H.
7. ALRC 57 para 9.12 - 9.16; ALRC 60, vol 1, proposed Pt 33.
8. See Corporations Law Pt 9.4B.

is liable to be penalised by the court.[9] The kinds of penalties that can be imposed are any of the following:

- a declaration that a contravention has occurred
- an order imposing a pecuniary penalty of up to $200 000 (but only if the contravention is a serious one)
- an order prohibiting the person from managing a corporation (civil penalty disqualification)
- an order for compensation to be paid to the affected company
- an order for punitive damages.

The proceedings in which any of these orders may be made are civil proceedings, not criminal proceedings. The contraventions involved are not offences unless the defendant, in contravening the relevant provision, acted knowingly, intentionally or recklessly or either dishonestly and intending to gain an advantage for himself or for some other person or with an intent to deceive or defraud. If the contravention is the subject of a criminal prosecution, rather than a civil penalty, and is proved to be an offence, the same maximum pecuniary penalty may be imposed (of up to $200 000) and imprisonment of up to five years is also available. The Corporations Law provides that taking civil proceedings for any of the civil penalty orders will operate as a bar on later criminal proceedings but taking criminal proceedings will not necessarily operate as a bar on subsequent civil proceedings for recovery by the company.

Contraventions by officers

15.9 *Applying the civil penalty regime.* The Review has adopted the principle that, wherever possible, there should not be a divergence between the regulatory approach adopted in relation to companies and that adopted in relation to collective investment schemes. This applies in the context of enforcement. The Review therefore **recommends** that the civil penalty regime be applied to contraventions by the directors and other executive officers of a company that is the operator of a collective investment scheme of the duties that they owe to the investors that are analogous to the duties set out in the Corporations Law s 232.[10] These are the duties

- to use the degree of diligence and care that a reasonable person in a like position would exercise in similar circumstances
- to act honestly in all matters concerning the scheme
- not to act in his or her own interest if that is not the same as the investors' interest
- not to make improper use of his or her position or of information acquired by virtue of his or her position.

15.10 *Dissent.* One member of the ALRC[11] disagrees with this recommendation so far as it contemplates that it should be possible to impose on an individual a pecuniary penalty otherwise than after conviction for an offence. In his view, such a

9. Corporations Law s 1317DA.
10. See para 10.18, 10.19, 10.20, 10.21.
11. Stephen Mason.

recommendation would be contrary to the requirement of the International Covenant on Civil and Political Rights (ICCPR) art 26 to accord equal protection of the law to all persons.[12] The imposition of a pecuniary penalty is in substance no different from the imposition of a fine. It is designed to punish those who contravene the law. The procedure for deciding whether there has been a contravention, and therefore whether punishment should be imposed, is, however, different from the procedure which must be followed before a court may find that a contravention of some other kind has occurred for which a similar punishment can be imposed. In the latter case, the court must be satisfied beyond reasonable doubt that the contravention has occurred. Under the Corporations Law Pt 9.4B Div 3 the court need only be satisfied on the balance of probabilities. It is true that, under the Corporations Law s 1317EA(5), the court may only impose a pecuniary penalty if satisfied that the offence is a 'serious' one. Under the *Briginshaw* test, the court will generally have regard to that fact in deciding whether it is so satisfied.[13] This does not alter the fact that the standard to which it must be satisfied before imposing a punishment of a similar type and severity to punishments for offences, is the civil standard. This member considers that it is contrary to art 26 to provide for the imposition of punishments — particularly similar punishments — on different standards of proof. The anomaly is compounded by the recommendation that similar obligations to those imposed on officers, breach of which will render the officers liable to a penalty on the civil standard, are also recommended to be imposed on the corporation that is the operator of the scheme. The ICCPR does not extend to protect bodies corporate: they do not have human rights. But, while exactly the same level of penalty is available to be imposed on an operator for a contravention, the standard of proof for the corporate operator is to be beyond reasonable doubt. In this member's view, the standard of proof for directors and officers ought to be the same, and ought to be the criminal standard.

Contraventions by scheme operators

15.11 Civil penalties are available in the corporate sphere chiefly in relation to a breach of the duties that the officers of a company owe to the company itself. The Review has recommended that they also be available in relation to a breach by officers of the operator of a collective investment scheme of the duties that the Review has recommended the officers owe directly to the investors in the scheme. The question now arises whether the civil penalty regime should be applied to the operator itself (the company) in relation to a breach by it of its obligations to investors.[14] The Review **recommends** that it not apply. The regime was designed in the context of breach by individuals of duties that they owe as individuals. It was not designed for breaches by bodies corporate. As the ALRC noted in its report *Sentencing* (ALRC 44, 1988), sanctions against corporations should be developed in the light of an overall policy about enforcement of regulatory laws and the

12. Under the *Law Reform Commission Act 1973* (Cth) s 7(b), the ALRC is bound to ensure that its recommendations in reports are consistent, so far as possible, with the articles of the International Covenant on Civil and Political Rights.
13. See *Briginshaw v Briginshaw* (1938) 60 CLR 336.
14. eg the obligation to act in the investors' interests, to treat investors equally and fairly: see para 10.8, 10.12.

traditional criminal law against corporations.[15] The ALRC has been asked by the federal Attorney-General to report on the most appropriate way to enforce the provisions of the *Trade Practices Act 1974* (Cth). That review will address the question of the appropriateness of civil penalty regimes in the corporate context. Whether some form of civil penalty regime should apply to corporations for breach of the collective investment provisions of the Corporations Law should await the outcome of that review.

The general power to excuse contraventions

15.12 The Corporations Law s 1318 allows the court to excuse a breach of the law, or negligence, default or breach of trust by an officer of a corporation. The provision is only available in civil proceedings, and is not a defence to a criminal proceeding.[16] The Federal Court or a Supreme Court may grant such relief prospectively. This provision will extend to officers of collective investment scheme operators in relation to the duties that the Review has recommended they should owe directly to investors.[17] No legislation is needed to achieve this. The result of this will be that an operator (the company) and its officers will need to obtain an exemption from the ASC to protect itself and themselves against criminal proceedings for a contravention, but that officers may also protect themselves against civil liability for breach of their special obligations by approaching the court.

Problems posed by corporate form

Introduction

15.13 Scheme operators, some temporary scheme operators apart, must be companies.[18] A number of problems arise in enforcing laws against bodies corporate simply because of their corporate form. These problems are most acute when the laws are criminal laws, but they are present also when the laws are civil laws, to be enforced through civil process. A body corporate is a legal fiction. It does not act itself but only through human agents. However, a corporation should not be liable for everything that its human agents do. That would be unjust to the shareholders of the corporation. Rules are needed to determine which acts of its agents will be attributed to the corporation. If an element of the offence or cause of action the subject of the proceeding is a 'fault' element or a 'mental element', rules will also be needed to determine whose fault or state of mind will be attributed to the corporation.

Attributing acts to the body corporate

15.14 ***Present law.*** The present law that determines when a body corporate will be criminally liable was summarised in ALRC 60 in the following way.

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15. ALRC Report No 44 *Sentencing* AGPS Canberra 1988, para 198.
16. It is available in civil penalty proceedings under Corporations Law Pt 9.4B.
17. See para 10.18-10.22: these duties are analogous to the duties that the officers owe the company.
18. See para 10.2.

- Decisions of the company in general meeting, and decisions of the board of directors, are decisions of the company.
- Directors can only act collectively as a board; the function of the individual director is to participate in discussions of the board.
- No director acting on his or her own, other than one appointed as a governing managing director, has authority to bind the company.
- A director as such is not a servant of the company. The managing director is a servant of the company 'and so generally a managing director combines the position of a director and employee'.

Under the principles laid down by the House of Lords the fault element of an offence will only be attributed to the company if the relevant knowledge or lack of care was on the part of

> the board of directors, the managing director and perhaps other superior officers of the company (who carry out the functions of management and speak and act as the company).[19]

This test is widely accepted as inadequate. The Commonwealth Review of Criminal Law commented:

> Having regard to these considerations, the Review Committee has concluded that the common law, largely because of the emergence of large corporations in modern times, does not make appropriate provision for the criminal liability of corporations. Further, the change required in the law to accommodate this development is of such dimensions that legislative action, rather than reliance on the evolution of the common law, is required.[20]

15.15 ***Reform.*** The Corporations Law s 762 provides for the attribution of acts and states of minds of officers to companies. It only has effect, however, in relation to Chapter 7 of the Corporations Law, not in relation to other provisions. It also attributes to the corporation acts done by persons at the direction of persons with relevant authority. It does not, however, prevent a 'defence' in circumstances where the body corporate was taking steps to prevent the acts being done. Subject to this comment, s 762 represents a significant improvement on the general law. There have been several recent reports which have considered the inadequacies of the present law. The Criminal Law Officers Committee (CLOC) of the Standing Committee of Attorneys-General reported in December 1992 on what general principles ought to apply uniformly in relation to criminal offences.[21] The Officers' proposal attributes the physical element of an offence to a corporation if the relevant act was done by a servant, agent, employee or officer acting in the scope of his or her employment or authority. If intention or knowledge is an element of

19. *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153.
20. Review of Commonwealth Criminal Law, *Interim Report, Principles of Criminal Responsibility and Other Matters* AGPS Canberra 1990, para 26.7.
21. Criminal Law Officers Committee of the Standing Committee of Attorneys-General, Final Report *Model Criminal Code, Chapter 2, General Principles of Criminal Responsibility* AGPS Canberra 1992.

the offence, it is to be attributed to the body corporate if the body corporate expressly tacitly or impliedly authorised or permitted the commission of the offence. Several means of proving this are provided for, including

- that the board of directors or a high managerial agent of the body corporate did or authorised the act (but there is a due diligence defence)
- that a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to the contravention
- that the body corporate failed to create and maintain a corporate culture that required compliance.

ALRC 60 suggested similar provisions to those in the CLOC draft. However, there are some differences.

- Directors, servants, agents etc of a body corporate who act within their actual or apparent authority from the body corporate will have their acts attributed to the body corporate unless acting only for their own benefit.

- Directors, servants and agents of a body corporate who do an act with a particular state of mind, intention or belief will have that state of mind, intention or belief attributed to the body corporate.

- Directors, servants and agents of a body corporate who
  - — within their actual or apparent authority from the body corporate, authorise another director, servant or agent to do an act and
  - — have a particular state of mind, intention or belief

  will have that state of mind, intention or belief attributed to the body corporate.

Again, the ALRC report would allow a 'due diligence' defence to the attribution of responsibility for the act to the body corporate:

> . . . it is a defence if it is established that the body corporate had taken all reasonable precautions, and had exercised due diligence, to prevent its officers, including its directors and employees, and its agents from doing the act.

However, the ALRC report expressly negates this defence if the person who did the act believed on reasonable grounds that reporting the matter to the board of directors or in accordance with the body corporate's reporting system would not have led to the body corporate taking effective measures to prevent the offence or would have led to the person being prejudiced.

15.16 ***Recommendation.*** The Review accepts the underlying principle of the Corporations Law s 762 and the thrust of the reform proposals that have been made. The Review **recommends**, consistently with ALRC 60, that all the acts of a body corporate's officers and agents that are within their actual or apparent authority should be attributed to the body. The automatic attribution of an act of a body corporate's servant or agent to the body would, however, produce injustice in two cases.

- ***Where the servant or agent acted only for his or her own benefit.*** If the servant or agent acted only for his or her own benefit and the body corporate did not benefit, it would be unjust to attribute liability to the body corporate.

- ***Where the body corporate took reasonable precautions.*** If the body corporate has taken reasonable precautions to prevent its servants and agents doing the act, it is unfair and unrealistic to attribute the act to the body. It is, in a practical sense, impossible for a corporation to prevent its servants and agents acting illegally. All that can be expected is that the corporation takes reasonable precautions and uses due diligence to prevent it. ALRC 60 recommended that it should be a defence to a prosecution if it is established that the accused took reasonable precautions and exercised due diligence to prevent its officers and agents from acting in the relevant way. The corporation would have to establish a system and monitor its operation regularly.[22] The Review agrees that an act done in defiance of the instructions of a body should not be attributed to the body if the body is making reasonable efforts to see that its instructions are adhered to.

The fact that the operator is licensed, and that some or all of the measures that it is taking have been imposed as conditions of the licence should not be taken into account in determining whether they were reasonable.

Attributing fault to the body corporate

15.17 Similar considerations apply to the attribution of the fault element of an act to the body corporate. The Review **recommends** that the state of mind of, or standard of care exercised by, the person who does an act that, under the previous recommendations, is attributed to the body corporate should also be attributed to the body. One further refinement is needed. Given the chain of command that usually exists in large corporations, the Review **recommends** that the state of mind of, or standard of care exercised by, the person who, within his or her actual or apparent authority, authorises or directs an act to be done should be attributed to the body as well.

Attributing knowledge to the body corporate

15.18 These recommendations apply in relation to criminal proceedings or civil penalty proceedings. There will however be the need from time to time to determine when a scheme operator has knowledge of a matter relevant to its obligations under the constitution or the Corporations Law in connection with civil proceedings, for example, civil actions for damages for breach of certain obligations, such as the obligation to act honestly, or certain actions based on constructive trusts, or where a person receives money knowing it to be paid in breach of trust.

22. ALRC 60 vol 2 para 9.25.

The Review **recommends** that attribution rules similar to those just recommended should apply in these cases. The knowledge possessed by, or the standard of care exercised by, a person who does an act with the authority of a scheme operator ought to be attributed to the scheme operator.

16. Transition to the new regime

Introduction

16.1 In previous chapters the report discusses the key elements of the regulatory regime proposed for collective investment schemes. The new regime will make a number of significant changes to the regulation of collective investment schemes including

- requirements for schemes to be registered and for licensing scheme operators
- requirements for scheme operators to have appropriate measures to ensure compliance with the law and the scheme's constitution
- increased obligations on the scheme operator to disclose information to the regulator and investors
- establishment of a common, minimum set of rights for investors
- new controls on withdrawing from schemes
- standard financial controls on collective investment schemes
- increased regulation of intermediaries
- increased powers for the regulator.

The implementation of this regime will need to take account of the many prescribed interest schemes established under the existing regime. Some of these changes can and should apply from the commencement of the regime. For others, a transition period will be needed. This chapter outlines the main issues to be dealt with in such a transitional phase.

'Grandfathering' schemes not an option

16.2 Some of the groups consulted by the Review suggested that some investors invest in prescribed interest schemes, especially unit trusts, because of the presence of a trustee independent of the manager. These investors, it was argued, are entitled to expect that that structure will not change. It was suggested that existing schemes should continue to be regulated under the current prescribed interest provisions. The Review regards 'grandfathering' schemes in this way as impractical as there would be two sets of laws governing collective investment schemes. This dual legal system would have to continue for many years, given the life-span of many current prescribed interest schemes. It may create considerable confusion and uncertainty for investors, while the regulatory costs to the ASC of administering two sets of laws could be prohibitive. The Review **recommends** that, with the exceptions indicated in this chapter, all schemes wishing to continue after commencement of the collective investment provisions of the Corporations Law should be required to meet the requirements of those provisions.

Application of particular recommendations

Registration, licensing and terminating schemes

16.3 Requiring each scheme to be registered and to have a single operator that holds a scheme operators licence is a key recommendation of this report. A reasonable period will be needed for existing schemes to make the necessary arrangements to change to the new system, for the decision who will be the operator to be made and for that party to seek a licence and have the scheme registered. Consultations by the Review suggest that about two years would be required for this purpose. The Review **recommends** that existing schemes should be given a two year period in which to convert from the existing regime to the new regime. The ASC should, however, be able to extend this period if appropriate. Either the trustee or the management company of an existing prescribed interest scheme will be able to apply to be licensed as scheme operator. The Review expects, however, that in most instances the management company will apply. The Review **recommends** that the consent of the party that does not apply for the licence should have to be attached to the licence application if the application is made within 18 months after the legislation implementing the Review's recommendations comes into effect. After that time, the management company should be able to apply without the consent of the trustee. If the manager is licensed as scheme operator, the trustee should have to transfer the scheme assets to the operator or to a custodian, as the operator directs, as soon as practicable. The costs of the transfer should be met out of the scheme funds. The Review **recommends** that the law should be amended to ensure that the transfer does not create a liability either to stamp duty or to capital gains tax. Finally, until a scheme is registered and a scheme operator licensed, the rules recommended in this report for terminating and winding up a scheme should not apply. Those matters should be governed by the present law.

Disclosure rules

16.4 Most of the recommendations in relation to disclosure can and should take effect in relation to existing schemes as soon as possible after the amending legislation is enacted. The requirement to disclose a scheme's registration number is an obvious exception: this will not be possible until the scheme has been registered by the ASC under the new regime. The Review **recommends** that all disclosure requirements that do not depend on the existence of a scheme number, such as the enhanced disclosure recommendations, should apply from the commencement of the amendments to the Corporations Law recommended in this report.

Financial controls

16.5 The new regime will, in most cases, limit the capacity of a scheme operator to borrow funds on behalf of the scheme. In most cases the funds borrowed must not be more than 10% of the value of the assets in the scheme unless the scheme is registered as a 'geared' scheme. Because there is no such restriction at present (other than the 20% cap imposed on unlisted property trusts), some schemes will need to be registered as geared schemes. The Review **recommends** that schemes should not have to comply with the recommended financial controls until they are registered under the new regime. In relation to auditing, however, including the requirement that auditors report breaches, the Review **recommends** that the requirements should apply to existing prescribed interest schemes as soon as the amending legislation commences.

Exit controls

16.6 Under the Review's recommendations, scheme operators will not be under a statutory obligation to purchase investors' interests on request. Operators will only be able to offer to repurchase investors' interests after specifying the amount they are prepared to spend. The ability of an investor to redeem his or her interests will also be matched more closely to the liquidity of the scheme. The changes the Review recommends in relation to leaving collective investment schemes are designed to minimise commercial instability. For this reason it would be desirable to introduce these changes at the earliest opportunity. The fact that they do not depend on any other aspect of the reforms means they can be introduced independently of other recommendations in this report. The Review **recommends** accordingly. Investors in many collective investment schemes, however, are not likely to notice any changes to their schemes.

Operator's obligations

16.7 The Review recommends that significant obligations be imposed on operators of collective investment schemes and their officers. They include obligations to maintain a minimum net value and to establish an informal dispute resolution mechanism and obligations similar to the statutory obligations that directors owe to companies. They have been formulated in the light of the overall impact of the recommendations on the structure and operation of schemes. The Review **recommends** that they should not be imposed in relation to a scheme until it is registered and a scheme operator licensed.

Investors' rights to information

16.8 Another set of rights recommended by the Review concerns the provision of information to investors.

- ***Access to information on demand.*** The Review has recommended that investors in all collective investment schemes should have access to information about the scheme on the same basis as investors in companies.[1] Investors in unit trusts and limited partnerships would, it seems, already have an equivalent right under the existing law. The Review **recommends** that this right should be available as soon as the amending legislation commences.

- ***Annual and other reports.*** The Review also recommends that scheme operators should provide annual reports to investors, and lodge with the ASC half yearly reports, with specific information, including:

1. See para 11.4.

- details of any purchase of interests by the scheme operator
- a change in the identity of the directors of the operator.

The Review **recommends** that these obligations should be imposed on managers of prescribed interest schemes for which there is an approved deed as soon as possible after the amending legislation is enacted.

Investors' power to dismiss or replace the operator and to amend the constitution

16.9 All investors in collective investment schemes will have a minimum set of rights. Three important rights are to dismiss the scheme operator, to replace it with another and to amend the constitution of the scheme.[2] Investors in unit trusts presently have a right to dismiss either the manager or the trustee. There is also a right to vote on certain amendments to the deed.[3] The Review **recommends** that investors should have the same right to dismiss the trustee or manager, after commencement of the amendments but before the scheme is registered and an operator appointed, as they would have to dismiss the operator under the new regime. Their existing rights should be superseded. However, rights of either the manager or trustee to call on the other to retire should continue. The Review **recommends** that the mechanism for amending the constitution of a prescribed interest scheme should not be changed until the scheme is registered.

Oppression remedy

16.10 The Review elsewhere recommends that investors should be able to apply to the court for relief on the grounds of oppression.[4] The Review **recommends** that this right should be available to investors in all collective investment schemes on commencement of the amending legislation. If oppression arises during the transition by a scheme to the new regime, the investors should be able to protect themselves by using this remedy.

Controls on intermediaries

16.11 The changes recommended in relation to intermediaries, apart from those relating to prescribed education standards, can and should apply as soon as the amending legislation commences. There is no reason why investors in existing schemes should not enjoy the benefits of the reforms (principally the increased disclosure to clients) at the earliest opportunity. The Review **recommends** that the controls on intermediaries recommended in the report should apply as soon as the amending legislation commences.

Regulator's powers

16.12 The recommendations in this report will, when enacted, give the ASC significantly increased powers to protect the interests of investors. There is no reason not to enable the ASC to use them as soon as possible. The Review

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2. Subject to the agreement of the operator: see para 11.22.
3. Corporations Law s 1069A.
4. See para 11.33.

recommends that as soon as the amending legislation commences the ASC should be able to exercise, in relation to both trustees and managers of prescribed interest schemes, all the powers it will have, including powers to conduct audit surveillances, in respect of scheme operators.

Appendix A
Covenants prescribed by the Corporations Law

COVENANT PRESCRIBED BY	PROVISION IN DRAFT LEGISLATION IN VOLUME 2

Covenants prescribed by s 1069

s 1069(1)(a)	unnecessary to reproduce
s 1069(1)(b)(i)	unnecessary to reproduce
s 1069(1)(b)(ii)	Corporations Law proposed s 216AB
s 1069(1)(b)(iii)	unnecessary to reproduce
s 1069(1)(c)	unnecessary to reproduce
s 1069(1)(d)	unnecessary to reproduce
s 1069(1)(e)(i)	closest equivalent Corporations Law proposed s 232AA
s 1069(1)(e)(ii)	unnecessary to reproduce
s 1069(1)(e)(iii)	Corporations Law s 289 as proposed to be amended
s 1069(1)(e)(iv)	Corporations Law s 323H
s 1069(1)(f)(i)	Corporations Law proposed s 323KA
s 1069(1)(f)(ii)	Corporations Law proposed s 323J
s 1069(1)(f)(iii)	Corporations Law proposed s 323KA
s 1069(1)(g)	Corporations Law proposed s 243HA
s 1069(1)(h)(i)	closest equivalent Corporations Law proposed s 323KC
s 1069(1)(h)(ii)	unnecessary to reproduce
s 1069(1)(j)	unnecessary to reproduce
s 1069(1)(k)	covered by Corporations Law proposed s 260BG
s 1069(1)(m)	procedures for calling meetings dealt with in Corporations Law proposed Division 2 of Part 3.4A; see proposed s 260BC

Covenants prescribed by reg 7.12.15

reg 7.12.15(1)(a)	unnecessary to reproduce
reg 7.12.15(1)(b)	unnecessary to reproduce — already covered by Corporations Law s 1040
reg 7.12.15(1)(c)	nearest equivalent Corporations Law proposed s 260AM
reg 7.12.15(1)(d)	Corporations Law proposed s 260AO
reg 7.12.15(1)(e)	unnecessary to reproduce
reg 7.12.15(1)(f)(i)	Corporations Law proposed s 260AE, 260AH

reg 7.12.15(1)(f)(ii)	Corporations Law proposed s 260AF, 260AH
reg 7.12.15(1)(g)	Corporations Law proposed s 260BE
reg 7.12.15(2)(a)	Corporations Law proposed s 113C
reg 7.12.15(2)(b)	covered by related party provisions
reg 7.12.15(2)(c)	unnecessary to reproduce
reg 7.12.15(2)(e), reg 7.12.15(8)	Corporations Law proposed s 158Q, 158R, 183C, 183D
reg 7.12.15(2)(f)	unnecessary to reproduce
reg 7.12.15(2)(g)	unnecessary to reproduce
reg 7.12.15(2)(h)	unnecessary to reproduce
reg 7.12.15(3),(4),(9)	Corporations Law proposed s 260BG
reg 7.12.15(5)(a)	Corporations Law proposed s 260AN
reg 7.12.15(5)(b)	Corporations Law proposed s 260AN
reg 7.12.15(5)(c)	Corporations Law proposed s 260AN
reg 7.12.15(5)(d)	best reproduced in regulations
reg 7.12.15(5)(e)	best reproduced in regulations
reg 7.12.15(5)(f)	Corporations Law proposed s 260AN
reg 7.12.15(5)(g)	Corporations Law proposed s 260AN
reg 7.12.15(5)(ga)	unnecessary to reproduce
reg 7.12.15(5)(gb)	unnecessary to reproduce
reg 7.12.15(5)(gc)	Corporations Law proposed s 323J
reg 7.12.15(5)(h)	unnecessary to reproduce
reg 7.12.15(5)(j)	unnecessary to reproduce
reg 7.12.15(5)(k)	unnecessary to reproduce
reg 7.12.15(5)(l)	unnecessary to reproduce; but see related party provisions and proposed s 183A
reg 7.12.15(5)(m)	unnecessary to reproduce
reg 7.12.15(5)(n)	unnecessary to reproduce
reg 7.12.15(5)(o)	Corporations Law proposed s 323KA
reg 7.12.15(5)(p)	best reproduced in regulations
reg 7.12.15(5)(q),(r)	dealt with by Corporations Law proposed s 260AJ
reg 7.12.15(5)(s)	unnecessary to reproduce
reg 7.12.15(5A)	unnecessary to reproduce
reg 7.12.15(5B)	unnecessary to reproduce
reg 7.12.15(6)(a)	Corporations Law proposed s 216BA
reg 7.12.15(6)(b)	unnecessary to reproduce
reg 7.12.15(6)(ba)	unnecessary to reproduce
reg 7.12.15(6)(bb)	Corporations Law proposed s 1020(2)
reg 7.12.15(6)(c)	nearest equivalent Corporations Law s 323H
reg 7.12.15(6)(d), reg 7.12.15(6)(e)	covered by enhanced disclosure provisions
reg 7.12.15(6)(f), reg 7.12.15(9)	Corporations Law proposed s 260BG
reg 7.12.15(6)(g), reg 7.12.15(10)	nearest equivalent Corporations Law proposed s 158Q, 158R, 183C, 183D
reg 7.12.15(6)(h)	unnecessary to reproduce
reg 7.12.15(6)(j)	unnecessary to reproduce
reg 7.12.15(6)(k)	unnecessary to reproduce
reg 7.12.15(6)(l)	unnecessary to reproduce
reg 7.12.15(6)(m)	nearest equivalent Corporations Law proposed s 232AA

reg 7.12.15(6)(n)	unnecessary to reproduce
reg 7.12.15(7)(a)	Corporations Law proposed s 323KA
reg 7.12.15(7)(b)	Corporations Law proposed s 323J
reg 7.12.15(7)(c)	covered by related party provisions
reg 7.12.15(7)(d)	Corporations Law proposed s 323J
reg 7.12.15(7)(e)	Corporations Law proposed s 260AJ
reg 7.12.15(7)(f)	Corporations Law proposed s 260AN
reg 7.12.15(7)(g)	unnecessary to reproduce
reg 7.12.15(7)(h)	Corporations Law proposed s 158K; 158L
reg 7.12.15(7)(j)	Corporations Law proposed s 158L
reg 7.12.15A	Corporations Law proposed Part 2.5

Appendix B
List of submissions

List of submissions to Issues Paper 10

Arnold RW	31 September 1991
ASGARD Capital Management Limited	13 November 1991
Association of Superannuation Funds of Australia Limited	18 November 1991
Attorney-General's Department (ACT)	19 November 1991
Australian Friendly Societies Association	1 November 1991
Australian Society of Certified Practising Accountants & The Institute of Chartered Accountants in Australia	24 December 1991
ANZ Funds Management Limited	29 October 1991
Australian Property Alliance	11 October 1991
Axtens JM	9 October 1991
Bankers Trust Australia Limited	1 December 1991
Baysys International (Aust) Pty Ltd	1 November 1991
Bowden RJ, National Centre for Banking and Capital Markets	22 October 1991
Boyle PJ	22 November 1991
Chamen P	8 October 1991
Eagle Star Trustees Limited	8 November 1991
Edwards A, Compliance Advisors	31 October 1991
Financial Wisdom Limited	5 December 1991
First State Fund Managers Limited	8 October 1991
Foley JF	8 November 1991
Freehill Hollingdale & Page	10 February 1992
Howard Financial Holdings Limited	28 April 1992
International Association for Financial Planning (Australia)	1 November 1991
Investment Funds Association of Australia	8 April 1992
KPMG Peat Marwick Chartered Accountants	6 December 1991
Law Council of Australia	21 February 1992
Life Insurance Federation of Australia Incorporated	25 November 1991
Macquarie Investment Management Limited	29 May 1992
MLC Investments Limited	22 November 1991
MLC Life Limited	13 November 1991
	2 March 1992
National Mutual Life Association of Australasia Limited	1 November 1991
	30 December 1991
Nipper MRG & Weeks PL	31 October 1991
Perpetual Trustees Australia Limited	1 November 1991
	15 November 1991
Premier and Cabinet, Dept of the (SA)	1 November 1991
Purvis, van Eyk & Company Limited	12 November 1991
Real Estate Institute of Australia	21 February 1992
Roach Retirement & Financial Planning Services Pty Ltd	21 October 1991
R Garton Smith & Co	2 January 1992
Skully MT, University of New South Wales	30 October 1991
Stokes & Company (Securities) Pty Ltd	31 October 1991

Trust Company of Australia Limited	4 October 1991
Trustee Companies Association of Australia	7 November 1991
Wells EM	28 October 1991
Westpac Banking Corporation,Westpac Financial Services	19 December 1991

List of submissions to Discussion Paper 53

ANZ Funds Management	7 December 1992
	21 December 1992
Arthur Robinson & Hedderwicks	10 December 1992
	16 December 1992
Attorney-General's Department, Business Law Division (Cth)	21 December 1992
Australian Copyright Council	23 December 1992
Australian Film Commission	7 January 1993
Australian Film Finance Corporation Pty Limited	8 December 1992
Australian Friendly Societies Association	22 December 1992
Australian Institute of Valuers and Land Economists (Inc)	8 December 1992
Australian Investors Association Ltd	16 December 1992
Australian Mutual Provident Society	30 November 1992
Australian Securities Commission	3 December 1992
Australian Society of Certified Practising Accountants & The Institute of Chartered Accountants in Australia	15 February 1993
Australian Stock Exchange Limited	22 December 1992
Baker H	26 November 1992
Bankers Trust Australia Limited	15 December 1992
Commercial Law Association of Australia Ltd	18 December 1992
Condell Vann & Co Australia Limited	12 November 1992
County NatWest Australia Investment Management Limited	18 December 1992
Credit Union Services Corporation (Australia) Limited	27 November 1992
Denyer JK	3 November 1992
Financial Planning Association of Australia Limited	7 December 1992
Finlayson R	18 December 1992
Freehill Hollingdale & Page	8 December 1992
Hall Chadwick Chartered Accountants	21 December 1992
Industry, Technology & Commerce, Dept of	21 December 1992
Institute of Actuaries of Australia	9 December 1992
Institute of Chartered Accountants in Australia	30 March 1993
Insurance and Superannuation Commission	12 November 1992
	16 December 1992
Investment Funds Association of Australia Limited	1 December 1992
Law Council of Australia	16 December 1992
Legal Services Commission of South Australia	15 December 1992
Lend Lease Property Funds Management	18 December 1992
Life Insurance Federation of Australia Incorporated	18 December 1992
Lismore Management Corporation Limited	10 March 1993
Little DJ	10 December 1992
Macquarie Investment Management Limited	24 November 1992
Mercantile Mutual Holdings Limited	16 December 1992
McAuley JP	23 November 1992
McMahon M	28 December 1992

Minter Ellison Morris Fletcher	19 November 1992
	24 November 1992
MLC Investments Limited	17 December 1992
MLC Life Limited	18 December 1992
National Information Centre on Retirement Investments	24 November 1992
National Mutual Life Association of Australasia Limited	30 June 1992
	6 November 1992
	3 December 1992
Permanent Trustee Company Limited	12 November 1992
	25 November 1992
	18 December 1992
Perpetual Trustees Australia Limited	10 December 1992
Property Resources	20 November 1992
Redfern Legal Centre	2 December 1992
Renton NE	3 December 1992
Reserve Bank of Australia	15 December 1992
Robinson WJ	14 October 1992
Roseman EM	17 February 1993
St George Funds Manager Limited	18 December 1992
Starr M	12 November 1992
Stokes & Company (Securities) Pty Ltd	26 November 1992
Sydney Futures Exchange Limited	11 December 1992
Treasury (Cth)	24 December 1992
Trust Company of Australia Limited	7 December 1992
Trustee Companies Association of Australia	10 December 1992
	17 December 1992
Tyndall Investment Management (Australia) Limited	26 November 1992
Valentine T	5 November 1992
Victorian Financial Institutions Commission	15 January 1993
Wessex Fund Management Limited	26 November 1992
Westpac Banking Corporation, Personal Investment Centres	3 December 1992
Westpac Banking Corporation, Westpac Financial Services	2 December 1992