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Corporations and Markets Advisory Committee

The establishment and operation of managed investment schemes

Discussion paper

March 2014

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Date for submissions

Please forward your submission by **Friday 6 June 2014.**

Contents

1 Introduction

This chapter provides an outline of CAMAC's review of managed investment schemes.

1.1 Overview

CAMAC's review of managed investment schemes has proceeded in two stages.

Stage 1, which culminated in the report *Managed Investment Schemes* in July 2012 (the 2012 CAMAC report), principally dealt with schemes or responsible entities (which manage schemes) in financial stress.

Stage 2, which forms the subject matter of this paper, deals primarily with the establishment and ongoing operation of schemes. It was foreshadowed in the 2012 CAMAC report and commenced after the completion of that report. CAMAC has undertaken this wider examination of schemes for a number of reasons, including its perception that a general review of this nature is timely, as the current managed investment scheme provisions were introduced in the late 1990s.

CAMAC sees both stages of this review as contributing to the Government's goal of promoting productivity, including by a reduction in the regulatory burden on industry. CAMAC's work in this area may also provide a useful adjunct to the work of the Government's Financial System Inquiry.

1.1.1 Stage 1: the 2012 CAMAC report

The 2012 CAMAC report considered matters relating to schemes for responsible entities (REs) in financial stress in the context of significant developments that have occurred with the use of schemes, in particular:

- the increasing use of contract-based 'common enterprise' entrepreneurial schemes (such as horticultural or forestry schemes) alongside more traditional trust-based 'pooled' investment schemes (such as cash management trusts or property funds)[1]

- the growing trend for REs to operate a number of schemes or to have other business operations of their own (multi-function REs), in contrast with REs whose only function is to operate one scheme (sole-function REs).[2]

These developments have raised complex issues concerning the adequacy of the current legal framework, both for the regulation of ongoing schemes and for the regulation of schemes or their REs that experience financial stress.

Schemes generally

The 2012 CAMAC report made a number of recommendations relevant to schemes generally:

- a prohibition on the creation of new common enterprise schemes

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1 The distinction between common enterprise and pooled schemes is discussed in Section 1.2.1 of this paper.
2 Sole-function and multi-function REs are discussed in Section 1.2.1 of this paper.

- a new regulatory structure for the operation of schemes, described as the Separate Legal Entity Proposal (SLE Proposal)
- a requirement that new schemes be operated only by sole-function REs (unnecessary if the SLE Proposal is introduced)
- a requirement that each scheme have a definitive register of scheme agreements and a definitive register of scheme property.

The SLE Proposal

The SLE Proposal was a key deregulatory recommendation in the Stage 1 report. It would simplify the procedures for making claims against scheme property, replacing the RE of a scheme and putting a scheme into external administration.

The SLE Proposal involved a registered MIS, which would be given the status of a separate legal entity, distinct from the RE or the scheme's members, for the purposes of:

- holding the legal title to all scheme property
- being the principal in all agreements entered into by the RE as agent of the MIS and operator of the scheme
- suing or being sued.[3]

This contrasts with the current position whereby the RE is the principal in all contracts involving the scheme and holds scheme property on trust for the scheme members.

An MIS would not have any directors, officers, members or employees, but would act exclusively through the RE, as its disclosed agent.[4]

The SLE Proposal is relevant to the following Stage 2 matters raised in this discussion paper:[5]

- the definition of scheme property[6]
- the provision specifying who is bound by the scheme constitution[7]
- the possible content of the disclosure requirements[8]
- the duties of officers of the RE[9]
- various notification requirements on the appointment of a receiver[10]
- the right of investors to avoid subscription contracts.[11]

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3 2012 CAMAC report Sections 1.6.2, 3.2.
4 2012 CAMAC report Section 3.2.
5 The SLE Proposal is also discussed in Section 7.5 of this paper, which deals with the related party transaction provisions, but does not change the analysis in that section.
6 Section 3.3.
7 Section 6.1.
8 Section 10.4.6.
9 Section 12.4.
10 Section 12.5.
11 Section 16.8.

CAMAC has considered each of these matters from two perspectives, namely if the SLE Proposal were implemented and if it were not.

The SLE Proposal does not have consequences for other matters discussed in this paper.

Other recommendations

The 2012 CAMAC report also made recommendations, relevant to schemes or REs in financial stress, that would decrease costs in these circumstances by providing simpler procedures:

- various ways to overcome the disincentives for an entity to act as a temporary responsible entity (TRE)[12]
- the adoption of a statutory concept of insolvency for schemes, similar to that applicable to corporations[13]
- facilitative provisions to permit a financially stressed scheme to be placed in voluntary administration[14]
- a winding up procedure for an insolvent scheme, comparable to that for winding up an insolvent company[15]
- giving scheme members statutory limited liability, similar to shareholders, and regardless of any contrary provision in a scheme constitution.[16]

1.1.2 Stage 2: this discussion paper

Issues covered

This paper reviews a wide range of issues relating to the establishment and operation of managed investment schemes. These issues include matters raised by respondents to Stage 1 of CAMAC's review of schemes,[17] as well as other matters that have come to CAMAC's attention. The issues raised in this paper cover the following areas:

- definitional matters[18]
- scheme registration[19]
- the governance framework for schemes, including the scheme constitution, the RE, and the compliance and risk management framework[20]
- matters relating to scheme members, including meetings[21]

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12 Chapter 5.
13 Section 6.3.2.
14 Chapter 6.
15 Chapter 7.
16 Section 8.4.3.
17 The respondents who raised other matters were ASIC, Freehills (now Herbert Smith Freehills), McCullough Robertson, the Insolvency Practitioners Association (now the Australian Restructuring Insolvency & Turnaround Association or ARITA), Ashurst Australia, Chartered Secretaries Australia (now the Governance Institute of Australia), Australasian Compliance Institute, Financial Services Council, Clarendon Lawyers and Messrs Bigmore, Hopper and Kennedy of the Victorian Bar.
18 Chapter 3, Sections 15.2, 16.1-16.5.
19 Chapter 4.
20 Chapters 5-7.

- disclosure[22]
- takeovers and reorganizations[23]
- external administration of schemes[24]
- regulatory powers and enforcement[25]
- international issues[26]
- other matters.[27]

Many of these issues involve areas where the law lacks clarity, which may result in uncertainty in the marketplace and undue administrative and legal costs in compliance. The paper discusses various options for reform that may help reduce compliance burdens.

Alignment of corporate and scheme law

A key principle that underlies CAMAC's views on many of the issues considered in this paper is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently, given that these two types of commercial enterprise often operate in the same markets and perform similar functions.

One reason for treating schemes differently in certain instances is that the governance framework for schemes differs from that for companies. Companies are under the direction and control of a board of directors. By contrast, a scheme is controlled by an RE, which must itself be a public company having its own directors.

Unjustified differences in applicable regulation open the way to unnecessary complexity. They also impose undue compliance burdens on those industry participants who operate schemes and companies (including through stapled entities). Alignment, where appropriate, achieves an overall deregulatory benefit of having similar legislative regimes for schemes and companies.

Professional indemnity insurance

A matter raised at Stage 1 of the CAMAC review concerned the minimum amount of professional indemnity insurance cover that should be held by the RE of a managed investment scheme. The report *Compensation arrangements for consumers of financial services: Report by Richard St. John* (April 2012) contains recommendations dealing with the adequacy of professional indemnity insurance cover for providers of financial services to retail consumers.[28] In consequence, this paper does not deal with professional indemnity insurance.

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21 Chapters 8-9.
22 Chapter 10, Section 16.6.
23 Chapter 11.
24 Chapter 12.
25 Chapter 13, Sections 16.10 and 16.11.
26 Chapter 14.
27 Sections 15.1 (valuation of scheme assets and liabilities), 15.3 (exception to the insider trading prohibition), 16.7 (failure to fulfil minimum subscription conditions), 16.8 (right of investors to avoid subscription contracts), 16.9 (certificates of interests).
28 Recommendations 2.1, 2,2, 2.3. See also paras 4.10, 4.24, 4.32, 4.34-4.42, 7.51.

1.2 Basic concepts

The 2012 CAMAC report and this paper draw two distinctions that are central to an understanding of how schemes operate and to the consideration of issues relating to managed investment schemes:

- the distinction between pooled schemes and common enterprise schemes
- the distinction between sole-function REs and multi-function REs.

1.2.1 Pooled schemes and common enterprise schemes

The statutory definition of 'managed investment scheme' refers to contributions from investors being 'pooled or used in a common enterprise'.[29]

Pooled schemes involve contributions by scheme members being pooled and becoming scheme property, for use in scheme investments or otherwise to operate the scheme. Schemes of this type are typically established as trust-based investment arrangements, with scheme members playing no active role in the affairs of the scheme.

Common enterprise schemes involve the use of member contributions in a common enterprise that constitutes the scheme, without those contributions being pooled. In these forms of entrepreneurial arrangements, a distinction must be drawn between scheme property and property owned by individual scheme members that is used in the operation of the scheme. Schemes of this type are typically established as contract-based arrangements, with scheme members playing an active entrepreneurial role to some degree, at least in theory.

1.2.2 Sole-function and multi-function REs

A sole-function RE is an entity whose only role is to operate one particular scheme.

A multi-function RE is an entity that is the operator of more than one scheme or is the operator of at least one scheme and has other dealings in its own right, such as conducting its own business. The legislation contemplates schemes being operated by multi-function REs.[30]

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29 Paragraph (a)(ii) of the s 9 definition of 'managed investment scheme'.

30 Subparagraph 601FC(1)(i)(ii) refers to an RE holding scheme property 'separately from property of the responsible entity and property of any other scheme'.

1.3 Terminology

For ease of reference, the following shorthand references are used in this discussion paper:

2012 CAMAC report	CAMAC report *Managed Investment Schemes* (July 2012)
AFSL	Australian financial services licence
AFS licensee	the holder of an AFSL
ALRC/CASAC report	joint Australian Law Reform Commission (ALRC)/Companies and Securities Advisory Committee (CASAC)[31] report *Collective Investments: Other People's Money* (1993)
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Report 291	ASIC Report 291 *Custodial and depository services in Australia* (July 2012)
ASIC Report 298	ASIC Report 298 *Adequacy of risk management systems of responsible entities* (September 2012)
ASX	Australian Securities Exchange
AUSTRAC	Australian Transaction Reports and Analysis Centre
common enterprise scheme	a scheme where contributions by members are to be 'used in a common enterprise' (para (a)(ii) of the definition of 'managed investment scheme' in s 9) (rather than those contributions being placed in a common pool) and where members typically enter into a series of agreements with the RE and/or other parties related to the ongoing operation of the scheme. In practice, this type of scheme may also be referred to as a contract-based scheme or an enterprise scheme
EU	European Union
FSC	Financial Services Council
FSC Standard No. 9	Financial Services Council Standard No. 9 *Valuation of Scheme Assets and Liabilities* (2006)
FSG	Financial Services Guide
FSRA	*Financial Services Reform Act 2001*
insolvent scheme	a scheme where the scheme property is insufficient to meet all the claims that can be made against that property as and when those claims become due and payable
IOSCO	International Organization of Securities Commissions

[31] In 2002, the name was changed to the Corporations and Markets Advisory Committee (CAMAC).

limited recourse rights	rights of recovery of a counterparty against an RE, under an agreement with that RE as operator of a scheme, that are limited to the scheme property available to the RE through the exercise of the RE's indemnity rights and exclude rights of recovery against the personal assets of the RE
MIS	the proposed separate legal entity under the SLE Proposal (summarised in Section 1.1.1 of this paper) that would hold all the scheme property and, through its RE as agent, would be the principal to all agreements involving scheme property
multi-function RE	an entity that is the operator of more than one scheme or is the operator of at least one scheme and has other dealings in its own right, such as conducting its own business
NAV	net asset value
NTA	net tangible assets
PDS	Product Disclosure Statement
personal assets of the RE	all assets of the RE, including assets acquired by the RE through dealings unrelated to its operation of any scheme and any funds that the RE has received through exercise of its indemnity rights against the property of any scheme that it operates. The term excludes scheme property and any other property held on trust by the RE. The term also excludes any unexercised indemnity rights of the RE against scheme property. While as a matter of law these unexercised indemnity rights form part of the personal assets of the RE, they are, for the purposes of this paper, not included in this definition, but are separately defined below
PJC	Parliamentary Joint Committee on Corporations and Financial Services
PJC Trio report	PJC report *Inquiry into the collapse of Trio Capital* (May 2012)
pooled scheme	a scheme where contributions by members 'are to be pooled' (para (a)(ii) of the definition of 'managed investment scheme' in s 9), typically in a trust-based investment arrangement, and where members typically do not enter into further agreements with the RE or any other party related to the ongoing operation of the scheme. In practice, this type of scheme may also be referred to as a passive or trust-based scheme
PPSR	Personal Property Securities Register, established under the *Personal Property Securities Act 2009*
RE	the responsible entity of a scheme, as defined in s 9
RG 94	ASIC/APRA, *Unit pricing: Guide to good practice* (2008) (ASIC Regulatory Guide 94)
RG 101	ASIC Regulatory Guide 101 *On-market buy-backs by ASX-listed schemes*
RG 104	ASIC Regulatory Guide 104 *Licensing: Meeting the general obligations* (2007)

RG 107	Regulatory Guide 107 *Fundraising: Facilitating electronic offers of securities* (March 2014)
RG 132	ASIC Regulatory Guide 132 *Managed investments: Compliance plans*
RG 133	Regulatory Guide 133 *Managed investments and custodial or depository services: Holding assets*
RG 134	ASIC Regulatory Guide 134 *Managed investments: Constitutions*
RG 168	ASIC Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)*
RG 198	Regulatory Guide 198 *Unlisted disclosing entities: Continuous disclosure obligations*)
scheme	a managed investment scheme, as defined in s 9
scheme creditors	all persons who have claims as creditors by virtue of having entered into agreements with the RE as operator of the scheme, except where the RE is acting as agent for scheme members. The rights of particular scheme creditors may differ, depending upon whether they have agreed to having only limited recourse rights (see above)
scheme members/members of a scheme	those persons who, pursuant to the definition of managed investment scheme in s 9, have contributed money or money's worth as consideration to acquire rights to benefits produced by the scheme
scheme property/property of a scheme	all property coming within the definition of 'scheme property' in s 9
SLE Proposal	the proposal in the 2012 CAMAC report under which each scheme would involve a separate entity, distinct from the RE or the scheme's members, for certain limited purposes (see Section 1.1.1 of this paper for additional detail about that proposal)
sole-function RE	an RE whose only function is to operate one scheme
subrogation remedy	the process by which counterparties to agreements with the RE as operator of a scheme can indirectly gain access to the property of that scheme through the indemnity rights of the RE regarding that property, as a means of satisfying their claims under those agreements
TRE	a temporary responsible entity appointed by the court to operate a scheme on an interim basis
Turnbull Report	*Review of the Managed Investments Act 1998* (2001) (the review was conducted by Mr Malcolm Turnbull)
UCITS	Undertakings for Collective Investment in Transferable Securities
unexercised indemnity rights of an RE	rights of an RE, not yet exercised, to be indemnified out of the property of a scheme in consequence of operating that scheme
VA	voluntary administration. A corporate VA is regulated under Part 5.3A of the Corporations Act.

1.4 The review process

CAMAC formed a subcommittee for this review, comprising Robert Seidler AM (chair), Michael Murray and Geoffrey Nicoll of CAMAC, James Marshall (Partner, Ashurst Australia, Sydney), David Proudman (Partner, Johnson Winter & Slattery, Adelaide) and Michelle Reid and Wen Leung of ASIC, in conjunction with the CAMAC Executive.

The subcommittee was adjusted in the final stages of settlement of this paper to include Joanne Rees, David Gomez, Teresa Handicott and Denise McComish of CAMAC.

CAMAC acknowledges the research by Milan Cakic of Allygroup on shorter Product Disclosure Statements for simple managed investment schemes and the shorter disclosure regimes for securities (Section 10.4), the work of ASIC officers in preparing the section on a UCITS-type regulatory structure for Australian funds (Section 14.3) and the work of Shaun Steenkamp of the Australian Accounting Standards Board in identifying accounting standards that are relevant to the valuation of scheme property (Section 15.1). CAMAC thanks them for their contribution to this discussion paper.

1.5 CAMAC

CAMAC is constituted under the *Australian Securities and Investments Commission Act 2001*. Its functions include, on its own initiative or when requested by the Minister, to provide advice to the Minister about corporations and financial services law and practice.

The members of CAMAC are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting.

The members of CAMAC are:

- Joanne Rees (Convenor)—Chief Executive Officer, Allygroup, Sydney
- David Gomez—Chief Financial Officer, Land Development Corporation, Darwin
- Teresa Handicott (Brisbane)—Partner, Corrs Chambers Westgarth
- Alice McCleary—Company Director, Adelaide
- Denise McComish—Partner, KPMG, Perth
- Michael Murray—Legal Director, Australian Restructuring Insolvency & Turnaround Association (ARITA) (formerly the Insolvency Practitioners Association), Sydney
- Geoffrey Nicoll—Co-Director, National Centre for Corporate Law and Policy Research, University of Canberra
- John Price—Commissioner, Australian Securities and Investments Commission (nominee of the ASIC Chairman)
- Ian Ramsay—Professor of Law, University of Melbourne
- Brian Salter—General Counsel, AMP, Sydney

- Greg Vickery AO—Special Counsel, Norton Rose Australia, Brisbane.

The chair of the CAMAC subcommittee on managed investment schemes, Robert Seidler AM (Chairman, Hunter Phillip Japan Ltd, Sydney), was also a member of CAMAC until April 2013. CAMAC thanks Mr Seidler for agreeing to continue as chair of the subcommittee after the end of his term as a member of CAMAC and the substantial work that he has contributed to this project.

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Thaumani Parrino—Office Manager.

2 Current position

This chapter summarises the way that schemes are established and regulated under the Corporations Act, as well as general law principles that apply to the operation of schemes. It indicates where these matters are dealt with in the 2012 CAMAC report and this paper.

2.1 Legal framework

The current legal framework for schemes, primarily set out in Chapter 5C of the Corporations Act, was introduced by the *Managed Investments Act 1998*.[32] The design of that legislation took into account the ALRC/CASAC report.

2.1.1 Legal structure of a scheme

Basic features

While there is no prescribed structure for a scheme, the various types of trust, contractual, limited partnership[33] and other entities have key common features, including:

- the contributions[34] of members of the scheme are either 'pooled' (typically in a trust-based arrangement) or are 'used in a common enterprise' (typically in a contract-based arrangement).[35] Most schemes are either pooled schemes or common enterprise schemes,[36] though some schemes can combine both types of arrangement.[37] Scheme members receive contractual or property 'interests' in the scheme,[38] which are 'financial products' regulated by Chapter 7 of the Corporations Act

- members do not have day-to-day control over the operation of the scheme (though under the terms of a scheme's constitution they may have the right to be consulted or to give directions in some instances)[39]

- the scheme is operated by a responsible entity (RE),[40] given that a scheme is not a separate legal entity and therefore cannot enter into legal agreements in its own right. In operating the scheme, the RE acts as the principal to agreements with external parties, except where (as in some common enterprise schemes) the scheme members themselves transact as the principals, which may involve using the RE as their agent.

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32 Collective investment vehicles were previously regulated as 'prescribed interests', which involved an approved deed, with responsibilities for the scheme divided between a management company and a trustee.

33 See, for instance, *Re Willmott Forests Ltd (No 2)* [2012] VSC 125 at [73]-[74].

34 Contributions can be in money or money's worth: subparagraph (a)(i) of the definition of 'managed investment scheme' in s 9.

35 Subparagraph (a)(ii) of the definition of 'managed investment scheme' in s 9.

36 This distinction between trust-based and contract-based structures was drawn by the Companies and Securities Law Review Committee (CSLRC) in 1987, using the terms fiduciary [trust] and non-fiduciary [contract] prescribed interests: CSLRC *Discussion Paper No 6—Prescribed Interests* (1987), Ch 4.

37 For instance, in *Commonwealth Bank of Australia v Fernandez* [2010] FCA 1487 at [86], the Federal Court referred to members in a common enterprise scheme having 'an interest in scheme assets that are acquired with pooled money'.

38 Subparagraph (a)(i) of the definition of 'managed investment scheme' in s 9.

39 Subparagraph (a)(iii) of the definition of 'managed investment scheme' in s 9.

40 s 601FB(1). One of the key initiatives recommended in the ALRC/CASAC report, and implemented in Chapter 5C, was the introduction of a single licensed RE to operate the scheme and hold scheme property on trust for scheme members. The RE replaced the previous two-tiered trustee and management company structure for the operation of these schemes.

As discussed in Section 1.1.1 of this paper, the 2012 CAMAC report recommended that this position be changed by the introduction of a separate legal entity, being a registered MIS, that would be distinct from the RE or members of the scheme.[41]

Some arrangements are specifically excluded from the definition of a scheme.[42]

The definition of 'managed investment scheme' is discussed in Sections 3.1 and 16.2 of this paper. Other definitions that are relevant to the managed investment scheme provisions are discussed in Sections 3.2, 3.3, 16.1 and 16.3-16.5.

Scheme property

The concept of 'scheme property' covers:

- contributions of money or money's worth to the scheme. If what a member contributes to a scheme is rights over property, the rights in the property that the member retains do not form part of the scheme property[43]
- money borrowed or raised by the RE for the purposes of the scheme
- property acquired, directly or indirectly, with, or with the proceeds of, contributions or money referred to above
- income and property derived, directly or indirectly, from contributions, money or property referred to above.[44]

Despite this apparently wide definition, whether property used in connection with a scheme is 'scheme property' as defined may depend on whether the scheme is one in which members pool their funds or is one in which members use their funds in a common enterprise. Common enterprise schemes are more likely than pooled schemes to have property of the members used in the enterprise.

The definition of 'scheme property' is discussed in Section 3.3 of this paper.

Pooled schemes and common enterprise schemes

Schemes that hold real estate or other assets for investment purposes are generally structured as trust-based pooled schemes, largely for tax reasons. In the listed property and infrastructure sectors, interests in these pooled schemes are often stapled to shares in an operating company, with the trust part of the structure owning the real estate or infrastructure. Scheme members hold shares in the corporate part of the structure and have a beneficial interest in the whole of the property of the trust.

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41 Section 1.6.2, Chapter 3 of the 2012 CAMAC report.

42 The definition of 'managed investment scheme' in s 9 of the Corporations Act sets out a number of specific exclusions. ASIC has pointed out that, in general, only investments that are 'collective' are schemes. Some examples given by ASIC of investments that are not schemes include:
- regulated superannuation funds
- approved deposit funds
- debentures issued by a body corporate
- barter schemes
- franchises
- direct purchases of shares or other equities
- schemes operated by an Australian bank in the ordinary course of banking business (eg term deposit).

43 Note 1 to the definition of 'scheme property of a registered scheme' in s 9.

44 Definition of 'scheme property' in s 9.

By contrast, common enterprise schemes are often structured as a series of bilateral or multilateral executory agreements between the member, the RE and various external parties. The 'scheme' in that case is not a pool of assets under management, but rather the common enterprise carried out over time in accordance with those agreements. For instance, for taxation or other reasons, various agribusiness common enterprise schemes were structured so that scheme members ('growers') operated their agribusiness investment in their own right, entering into agreements with the RE or external parties to perform the cultivation and management activities associated with the member's enterprise. Scheme members would hold various forms of proprietary or contractual interests in allocated parcels of land, which may be owned by an external party.[45] In that type of common enterprise scheme, complex problems can arise in determining the nature of the rights of scheme members, and clearly distinguishing during the operation of the scheme between the property of the scheme and the property of scheme members used in the enterprise.[46]

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[45] In *BOSI Security Services Limited v Australia and New Zealand Banking Group Limited & Ors* [2011] VSC 255, at [1]-[3] and [12]-[14], the Court described the structure of one agribusiness involving a common enterprise as follows:

> The Timbercorp group of companies went into administration on 23 April 2009. On 29 June 2009, the creditors voted at their second meeting for the companies to be wound up and the companies, which included the second defendant ("AL"), were placed into liquidation. ...
>
> Before liquidation, the Timbercorp group had established, managed and operated several horticultural managed investment schemes. These schemes had included managed investment schemes for the cultivation and harvesting of almonds for commercial gain. Five of the schemes (collectively "the Almond Projects") had used commercial almond orchards established by AL on its land, which AL made available for the purposes of the projects. Investors in these projects ("growers") subscribed for interests in "Almondlots", which carried rights to use and occupy AL's orchards for the terms of the projects of which they were members ("the growers' rights").
>
> All of the Almond Projects had many years left to run when the Timbercorp group went into external administration but the insolvency of the Timbercorp group had the consequence that the Timbercorp companies could not continue their involvement in the projects. The liquidators brought the projects to an end when they extinguished the growers' rights on 2 December 2009 so that they could sell AL's land, almond trees and water licences ("the Almond Assets") free of any encumbrance on title. ...
>
> ... At the time that the Timbercorp group was placed under administration, the group had thirty three managed investment schemes registered with the Australian Securities and Investments Commission ("ASIC") under Part 5C of the Corporations Act 2001 (Cth) ("the Act"). Timbercorp Securities Ltd ("TSL"), a wholly owned subsidiary of TL and the holder of an Australian financial services licence, was the responsible entity ("RE") of these schemes. ...
>
> The registered projects and the 2002 private offer project were conducted on AL's land and used AL's almond orchards and infrastructure, including its water licences and irrigation equipment. Although the legal structures differed, it was a key feature of each project that the Almond Assets remained AL's property. The project documents only gave growers rights to use and occupy AL's property for the terms of their projects for the purpose of cultivating and harvesting almonds.
>
> Growers participated in the projects by subscribing for Almondlots and paying a fee per Almondlot. Subscription was by application and the completion of a power of attorney. By signing the application the grower agreed to be bound by the constituent legal documents governing the project. By completing the power of attorney the grower appointed the attorney to enter into the applicable agreements underpinning the projects on the grower's behalf.

[46] For instance, in *BOSI Security Services Limited v Australia and New Zealand Banking Group Limited & Ors* [2011] VSC 255, the Court held, on the facts, that the members of the common enterprise scheme had only a contractual, not a proprietary, interest in certain land used in the operation of that scheme. Those contractual rights were insufficient to establish their entitlement to share in the proceeds of the sale of that land. In *Re Willmott Forests Ltd (No 2)* [2012] VSC 125 at [59] ff, the Court gave consideration to whether certain freehold and leases should be taken to have been 'contributed' to the schemes and therefore would constitute scheme property.

Trust and non-trust elements

There are some key trust elements that are applicable to all schemes, whether pooled or common enterprise schemes, in particular:

- the RE holds scheme property on trust for scheme members.[47] It has been held that, in consequence, an RE is a 'trustee' for the purposes of the court's jurisdiction to provide judicial advice and direction to an RE under relevant state trustee legislation[48]

- the RE's rights to recover from scheme property for its remuneration and expenses in operating the scheme are derived from the constitution of the scheme[49] and based on trust law indemnity principles.

On the other hand, there are areas where the legislative structure for schemes differs from the general law of trusts. For instance, the Corporations Act sets out a regime for the transfer of rights, obligations and liabilities where the RE of a scheme changes,[50] independently of any trust law principles applicable when there is a change of trustee.[51] The 2012 CAMAC report recommended modifications to this regime in the event that the SLE Proposal is not adopted.[52] If the SLE Proposal is adopted, these transfer procedures would be redundant.

Also, under general trust law, there is no such thing as the formal winding up of a trust. The trust simply comes to an end in certain circumstances and the property is distributed among the beneficiaries.[53] By contrast, the legislation regulating schemes contains various provisions for their winding up.[54]

The winding up procedures are discussed in Section 2.5 of this paper and in Chapter 7 of the 2012 CAMAC report.

2.1.2 Registration of a scheme

All schemes must be registered except for 'private' schemes and 'wholesale' schemes[55] (the discussion in this paper will deal with registered schemes except where otherwise

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47 s 601FC(2). There may be a difference of view whether this section only applies to scheme property in fact held by the RE (in which case that property is held on trust) or extends to any scheme property, whether or not in fact held by the RE (in which case all scheme property is deemed to be held by the RE and held on trust).

48 *Mirvac and Mirvac Funds* [1999] NSWSC 457 at [41]:

> [S]ection 601FC(2) states that the responsible entity holds scheme property (in this case the property of the respective trusts) on trust for scheme members (in this case the respective unitholders). There are therefore express trusts here and each responsible entity clearly falls within the definition of the 'trustee' for the purposes of section 63 [of the *Trustee Act 1925* (NSW)]. I see nothing in Chapter 5C of the Corporations Law to suggest that it is intended to exclude the Court's jurisdiction to provide judicial advice to a responsible entity under general trustee legislation.

See also *In the matter of Centro Retail Limited and Centro MCS Manager Limited in its capacity as Responsible Entity of Centro Retail Trust* [2011] NSWSC 1175 at [3], *Re Elders Forestry Management Ltd* [2012] VSC 287 at [6]-[7], *Sydney Airport Holdings Limited as responsible entity of Sydney Airport Trust 2* [2013] NSWSC 1665 at [4].

49 s 601GA(2).

50 ss 601FS, 601FT.

51 Some of the legal issues that arise at general law when there is a change of trustee are discussed in V Stathakis & S Harrison, 'Practical consequences of a change of trustee on receivers and secured creditors' (2011) 11(8) *Insolvency Law Bulletin* 155.

52 Section 5.8.3.

53 See, for instance, *Westfield QLD No. 1 Pty Limited v Lend Lease Real Estate Investments Limited* [2008] NSWSC 516.

54 Part 5C.9.

55 s 601ED. The process of registration with ASIC is set out in Part 5C.1.

indicated). There is provision for the winding up of schemes that should have been, but have not been, registered.[56]

Issues relating to scheme registration are discussed in Chapter 4 of this paper.

2.1.3 Governance framework for schemes

The RE

A registered scheme must have an RE, which operates the scheme and must be a public company that holds an Australian financial services licence permitting it to operate the scheme.[57] This licensing system imposes certain obligations on REs, including that they have available adequate financial resources to provide the financial services covered by their licence[58] and adequate risk management systems.[59] A scheme may be deregistered by ASIC if it does not have an RE that meets these requirements.[60]

The RE's role as operator of the scheme is discussed in Section 2.2 of this paper. Section 5.2.1 discusses in more detail the governance requirements that apply to the RE and its officers and employees, including the licensing regime for REs. Section 5.4 provides additional details about the risk management requirements for REs.

Replacement of the RE is discussed in Section 2.1.5 of this paper.

Chapter 7 of this paper discusses issues relating to the RE and others involved in the operation of a scheme.

Constitution and compliance framework

A registered scheme must have a scheme constitution,[61] a compliance plan[62] and, in certain circumstances, a compliance committee.[63]

The scheme constitution as part of the governance framework is discussed in Sections 5.2.2 and 6.1 of this paper, while its enforceability and the procedure for changing it are discussed in Sections 6.2 and 6.3, respectively.

The compliance plan and the compliance committee are discussed in Section 5.3.

2.1.4 Investing in a scheme

The process of offering interests in a scheme is regulated by various disclosure requirements, including that potential retail investors must be given a product disclosure statement, and other related documents, in advance of any investment.[64] ASIC has also

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56 s 601EE.

57 ss 601FA, 601FB. The general obligations of licensees are set out in s 912A.

58 s 912A(1)(d). See ASIC Regulatory Guide 166 *Licensing: Financial requirements* (November 2013), Pro Forma 209 *Australian financial services licence conditions* (PF 209) and CO 13/760 *Financial requirements for responsible entities and operators of investor directed portfolio services*. The aim is to ensure that REs have adequate resources to meet operating costs and there is an appropriate alignment with the interests of scheme members.

59 s 912A(1)(h).

60 s 601PB(1)(a).

61 Part 5C.3.

62 Part 5C.4.

63 Part 5C.5.

64 An interest in a scheme is a 'financial product' for the purposes of Chapter 7 of the Corporations Act (Part 7.1 Div 3). The disclosure requirements for financial products are set out in Part 7.9. They contain detailed requirements for disclosure to a 'retail client' (as defined in ss 761G, 761GA).

provided disclosure guidance for various types of schemes, including mortgage schemes, property schemes, infrastructure funds, hedge funds and agribusiness schemes.[65]

The disclosure requirements for interests in schemes are discussed in Chapter 10 of this paper. Section 5.7 discusses disclosure of a scheme's investment guidelines.

2.1.5 Replacement of the RE

There are procedures for replacing an RE, including the appointment of a temporary responsible entity (TRE) as an interim measure while a new RE is sought.[66] A common goal of these procedures is to avoid a scheme being without an RE for any period of time, given that the role of the RE is to operate the scheme.[67]

Where an RE is replaced, the rights, obligations and liabilities of the outgoing RE under agreements into which it has entered (or that it has inherited from any prior RE) as operator of the scheme are transferred to the incoming RE (including any TRE) through a statutory novation process.[68] The ostensible purpose of this transfer is to ensure that the rights of counterparties are not affected where the RE of a scheme changes. Except when an RE is acting as agent for scheme members (who then become the principals), the RE transacts as the principal in operating a scheme. As principal, the RE personally takes on the rights, obligations and liabilities under each agreement into which it enters as operator of the scheme, unless the counterparty agrees otherwise. These personal rights, obligations and liabilities of an RE are transferred to a TRE or new RE through the novation process.

Replacement of the RE was discussed in Chapter 5 of the 2012 CAMAC report. Section 7.6 of this paper discusses an additional issue relating to replacement of the RE.

2.1.6 Position of scheme members

A member of a managed investment scheme is a person who holds an interest in the scheme.[69] The definition of 'member' is discussed in Section 3.2 of this paper, while the test for determining when a person ceases to be a scheme member is discussed in Section 9.5.

Members of a scheme have no day-to-day control over the operation of the scheme.[70] However, meetings of scheme members may be called for various purposes, including to replace the RE,[71] to alter the scheme constitution,[72] to approve various related party

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65 Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors*, Regulatory Guide 46 *Unlisted property schemes: Improving disclosure for retail investors*, Regulatory Guide 231 *Infrastructure entities: Improving disclosure for retail investors*, Regulatory Guide 232 *Agribusiness managed investment schemes: Improving disclosure for retail investors*, Regulatory Guide 240 *Mortgage Hedge funds: Improving disclosure*.

66 Part 5C.2 Div 2.

67 s 601FB(1).

68 ss 601FS, 601FT. What is involved in the concept of rights, obligations and liabilities, and what agreements might be covered under this provision, are discussed in *Investa Properties Ltd* [2001] NSWSC 1089 at [11], *Syncap Management (Rural) Australia Ltd v Lyford* [2004] FCA 1352 at [41]-[57], *Australian Olive Holdings Pty Ltd v Huntley Management Ltd* [2009] FCA 1479 at [114]-[120], *Huntley Management Ltd v Timbercorp Securities Ltd* [2010] FCA 576 at [43]-[50], [65]-[66] and *Primary RE Limited v Great Southern Property Holdings Limited (recs & mgrs apptd) (in liq) & Ors* [2011] VSC 242 at [166]-[181], [199]-[208].

69 Paragraph (a) of the definition of 'member' in s 9.

70 Subparagraph (a)(iii) of the definition of 'managed investment scheme' in s 9.

71 s 601FM.

72 s 601GC(1)(a).

financial benefits[73] or to direct that the scheme be wound up.[74] There are statutory procedures for calling and holding meetings, as well as voting on resolutions and gaining access to the minutes of members' meetings.[75]

Issues relating to meetings of scheme members are discussed in Chapter 8 of this paper.

Members may inspect the register of scheme members without charge.[76] Issues relating to the access of scheme members to the register are discussed in Section 9.1 of this paper.

Scheme members do not have an automatic right to inspect scheme accounts or other documents, unless this right is provided for in the scheme constitution or some other scheme document. However, the court may order that a scheme member have access to books of the scheme if the court is satisfied that the applicant is acting in good faith and that the inspection will be made for a proper purpose.[77] The court may also make ancillary orders, including restricting the use that a person who inspects the books may make of the information obtained.[78]

There are statutory provisions governing the right of members to withdraw from a scheme.[79] The procedures governing any withdrawal rights differ depending on whether the scheme is liquid or non-liquid. The withdrawal procedures and the possibility of a statutory buy-back procedure for schemes are discussed in Sections 9.2-9.4.

There are also provisions dealing with the consequences for members of certain contraventions by promoters or the RE.[80]

2.1.7 Takeover s and reorganizations

The takeover and compulsory acquisition provisions in Chapters 6, 6A and 6B of the Corporations Act apply to the acquisition of interests in listed schemes.[81] Attempts to entrench an RE of a listed trust may amount to 'unacceptable circumstances' for the purposes of Chapter 6.[82]

A reorganization or change of control of a company may be achieved through a scheme of arrangement under Part 5.1 of the Corporations Act. These provisions do not apply to schemes. Instead, changes of control or other reorganizations of schemes have tended to proceed through 'trust scheme' arrangements. There is no equivalent in these arrangements of the judicial and other procedural protections applicable to corporate schemes of arrangement under Part 5.1, though the proponents of a trust scheme may choose to seek judicial direction or advice on its implementation.

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73 The related party transaction provisions in Chapter 2E of the Corporations Act are applied, with modifications, to schemes by s 601LA. See Part 5C.7. Those provisions are discussed in Section 7.5 of this paper.

74 s 601NB.

75 Part 2G.4. In general, the RE and its associates are not entitled to vote their interests on a resolution if they have an interest in the resolution or matter other than as a scheme member: s 253E. This provision is discussed in Section 8.4 of this paper.

76 s 173(2).

77 s 247A.

78 s 247B.

79 Part 5C.6.

80 Part 5C.8.

81 s 604. See also ASIC Regulatory Guide 74 *Acquisitions approved by members* and Takeovers Panel *Guidance Note 15: Trust Scheme Mergers*.

82 *Re AMP Shopping Centre Trust (No 1)* (2003) 45 ACSR 496 at [66].

The CAMAC report *Members' schemes of arrangement* (2009) recommended the extension of the Part 5.1 scheme of arrangement provisions to listed and unlisted schemes.[83]

Takeovers and reorganizations of schemes are discussed in Chapter 11 of this paper.

2.2 The RE transacting as operator of a scheme

2.2.1 Overview

A scheme is not a separate legal entity and therefore cannot enter into agreements in its own right. In a pooled scheme, the RE acts as principal in operating the scheme and is personally liable under each agreement into which it enters in that capacity, except where the counterparty agrees otherwise. Scheme members are not parties to those agreements. Likewise, in common enterprise schemes, the RE transacts as principal in operating the scheme (and is personally liable, unless the counterparty agrees otherwise), except where the members themselves enter into agreements as principals, using the RE as their agent for this purpose. To assist the RE in acting as agent for scheme members, it has been the practice with some common enterprise schemes for the application form signed by any person seeking to become a scheme member to contain a grant of a power of attorney to the RE.[84]

A counterparty to an agreement where the RE acts as principal may agree to limit its rights of recovery against the RE to the amount for which the RE can be indemnified from the property of the scheme (limited recourse rights), thereby excluding rights of recovery against the personal assets of the RE. It is common for limited recourse rights clauses to be incorporated in agreements drawn up by an RE as operator of a scheme.[85] Limited recourse rights are discussed in the context of notification of the appointment of a receiver in Section 12.5 of this paper.

As discussed in Section 1.1.1 of this paper, the 2012 CAMAC report recommended the introduction of a separate legal entity, being a registered MIS, that would be distinct from the RE or members of the scheme.[86]

2.2.2 Indemnity rights of the RE

An RE, as operator of a scheme, and as the principal to agreements into which it enters in that capacity, has rights to be indemnified out of the property of that scheme, by application of trust law principles, for:

- its remuneration and expenses in operating the scheme
- the obligations or liabilities that it personally incurs under those agreements.[87]

It has long been recognised that a trustee can resort to the property of the trust to discharge a liability that it has properly incurred as trustee of that trust.[88] A trustee can:

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83 Sections 7.2 and 7.6.2.
84 See, for instance, *Re Elders Forestry Management Ltd* [2012] VSC 287 at [15].
85 In some schemes, the RE may contract out its management role to another party, with agreements involving outside parties also containing limited recourse rights to protect the manager against personal liability.
86 Section 1.6.2, Chapter 3 of the 2012 CAMAC report.
87 The applicable trust law principles are summarised in *JA Pty Ltd v Jonco Holdings Pty Ltd* [2000] NSWSC 147 at [50].

- apply the trust property directly in discharging the liability,[89] or
- itself discharge the liability and then exercise a right to be reimbursed from the property of the trust for the costs it has incurred.[90]

These trust law principles are summarised in one case as follows:

> The trustee is entitled to be indemnified out of the trust assets in respect of liabilities which it incurs in the course of administering the trust, but is personally liable to creditors in respect of such liabilities unless it has contracted with a creditor to limit the creditor's recourse against it. If the trustee has discharged the liability out of his individual property, he is entitled to reimbursement from the trust fund. If he has not discharged it, he is entitled to be exonerated from the trust fund for the liabilities properly incurred in the administration of the trust. He cannot be compelled to surrender the trust property to the beneficiaries until his claim has been satisfied.[91]

These indemnification rights of a trustee are available to an RE of a scheme only if:

- they are specified in the constitution of the scheme, and
- the RE has properly performed its duties.[92]

The RE will not have an indemnity claim against the property of the scheme where the RE has acted beyond power (including outside the terms of the scheme constitution) or otherwise improperly.[93] This statutory limitation on an RE's right of indemnity is reinforced by the general trust law limitation whereby a trustee's right of indemnity is subject to, and diminished by, any lawful claim by beneficiaries against the trustee in connection with breaches by the trustee, for instance misappropriation, or neglect, of scheme property.[94]

Any attempt in a scheme constitution or otherwise to deny a lawful indemnity right of the RE, otherwise given in the constitution, because the RE has gone into external administration, is void.[95]

The question of what constitutes proper performance of an RE's duties is discussed in Section 7.2 of this paper.

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88 *Worrall v Harford* (1802) 8 Ves Jun 4.

89 In trust law this is described as the 'right of exoneration'.

90 In trust law this is known as the 'right of recoupment' or the 'right of reimbursement'.

91 *Stacks Managed Investments Ltd* [2005] NSWSC 753 at [43]. See also *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53, which held that the trust fund available to the beneficiaries of a trust could not be identified and quantified until the trustee's superior indemnity rights concerning those funds had been quantified and satisfied.

92 s 601GA(2).

93 s 601GA(2). This is based on trust law principles. See, for instance, *General Credits Ltd v Tawilla Pty Ltd* [1984] 1 Qd R 388 at 389-390, *RWG Management Ltd v Commissioner for Corporate Affairs* [1985] VR 385. See also RI Barrett, 'Insolvency of registered managed investment schemes', Paper delivered at the Conference of the Banking and Financial Services Law Association, Queenstown, July 2008, pp 5-7.

94 This 'clear accounts' rule and its consequences are discussed by N D'Angelo, 'The unsecured creditor's perilous path to a trust's assets: Is a safer, more direct US-style route available?' (2010) 84 *Australian Law Journal* 833 at 841-848.

95 s 601FH. This adopts a recommendation of the ALRC/CASAC report (vol 1, para 8.8), endorsing a recommendation of the ALRC's *General Insolvency Inquiry* (ALRC 45) (the Harmer Report) vol 1, para 251; vol 2, s T3 (see also vol 1, para 271 of the Harmer Report for the application of this provision to the administrator and deed administrator).

2.2.3 Rights of counterparties

A scheme is not a legal entity[96] and therefore cannot enter into agreements in its own right. Instead, the RE, as scheme operator, transacts as principal to all agreements into which it enters in that capacity, except where it specifically acts as agent for another party.[97]

As discussed in Section 1.1.1 of this paper, the 2012 CAMAC report recommended the introduction of a separate legal entity, being a registered MIS, that would be distinct from the RE or members of the scheme.[98]

Where RE provides security

A counterparty can enforce any security lawfully[99] granted to it by an RE[100] when acting, as principal or agent, in any capacity. For instance, the RE may provide particular scheme property as security for an external financier that is funding the scheme under a limited recourse rights arrangement.

Where RE acts as agent

Where an RE has entered into agreements solely as the agent for members of a scheme (as in some common enterprise schemes), counterparties will have remedies against those members only, provided that the RE has acted within its agency powers. These agreements may include provisions that terminate or otherwise affect rights on the happening of certain events, such as the scheme being wound up.[101] If an RE has acted ostensibly as an agent for scheme members, but beyond its agency powers, counterparties may have remedies against the RE only (applying relevant agency law principles).

Under the SLE Proposal, the RE would always be acting in the capacity of agent, regardless of the type of scheme. If common enterprise schemes continue to be permitted, the RE would continue to be an agent of scheme members in those common enterprise schemes that so provide. In other cases, it would be an agent of the MIS.

Where RE acts as principal

Where the RE enters into an agreement as principal in operating a particular scheme, then, by application of general law principles, and subject to the counterparty having agreed to limited recourse rights only, the counterparty will have:

- a direct right against the personal assets of the RE (which include funds already received by the RE through the earlier exercise of its indemnity rights against the property of that scheme, or any other scheme that it operates), and

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96 *Capelli v Shepard* [2010] VSCA 2 at [92].

97 Where an RE enters into an agreement, consideration may need to be given to the terms of the agreement and other surrounding circumstances to determine whether the RE has acted as operator of a particular scheme. This is based on trust law principles, as set out in *Re Interwest Hotels Pty Ltd (in liq)* (1993) 12 ACSR 78.

98 Section 1.6.2, Chapter 3 of the 2012 CAMAC report.

99 For a security to be properly given over scheme property, the RE must have express power to give the security and must give the security in the due administration of the trust: P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶81-100.

100 Where assets of a scheme are held by a custodian acting as agent for the RE, it may be necessary for the security to be executed by the custodian: P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶81-200.

101 See, for instance, *Re Elders Forestry Management Ltd* [2012] VSC 287 at [13].

- an indirect subrogation remedy in relation to any unexercised indemnity rights of the RE against the property of that scheme.[102] Counterparties cannot make a direct claim on the property of that scheme, which is held in trust by the RE for scheme members.[103]

A counterparty with limited recourse rights has no rights against the personal assets of the RE. Limited recourse rights are similar to the indirect subrogation remedy in that both are limited to the lawful indemnity claims that the RE can make against available scheme property.

As previously indicated (Section 2.2.2), an RE may lose its right of indemnity in various circumstances. In consequence, the improper conduct of the RE may affect the capacity of counterparties with limited recourse rights to obtain recovery from scheme property, or for other counterparties to exercise their subrogation remedies in relation to scheme property.

One judge, speaking extra-judicially, has summed up the position in the context of trusts:

> The trustee's [indemnity] rights ... are fragile things. And their fragility may rebound upon creditors. The beneficiaries' interest in trust property will not be postponed to a beneficial interest of the trustee unless the trustee's interest exists. If the trustee's interest does not exist, the trust property is shielded from the claims of the trustee's creditors.[104]

Counterparties may also be disentitled from claiming against scheme property under the subrogation remedy by their own behaviour. One commentator[105] has summed up the position as follows:

> Some in commerce, including lawyers, refer to a 'right' of subrogation. In fact, it is not a right at all, or even a cause of action, but rather an equitable remedy acting on the conscience of the trustee.[106] Being a creature of equity, it is discretionary and subject to all the usual rules for engaging equitable remedies. This means that an enforcing unsecured trust creditor may be denied subrogation by application of disentitling equitable defences such as unconscionability, laches, acquiescence, waiver, estoppel, clean hands, or who comes to equity must do equity. Potentially, parties with something to gain (for example, the beneficiaries or even competing trust creditors) could manoeuvre to deny an unsecured trust creditor its claim to subrogation and, therefore access to the trust assets, by seeking to demonstrate disentitling behaviour on the part of the creditor, leaving it to its rights against the trustee personally and a share out of the trustee's personal assets (if any) in liquidation.

Where an RE goes into external administration, uncertainty remains about who can claim against any property recovered by its external administrator through exercise of any previously unexercised indemnity rights of the RE. One line of trust law authority is that, in the insolvency of a trustee, funds recovered under the trustee's right of indemnity out of

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102 This is based on trust law principles, as summarised by the High Court in *Octavo Investments Pty Ltd v Knight* [1979] HCA 61 at [13]-[16], [30].

103 s 601FC(2). In *Octavo Investments Pty Ltd v Knight* [1979] HCA 61 at [30], the High Court indicated that trust property itself cannot be taken in execution by the creditors of the trustee.

104 RI Barrett (now a judge of the NSW Court of Appeal), 'Insolvency of registered managed investment schemes', Paper delivered at the Conference of the Banking and Financial Services Law Association, Queenstown, July 2008, p 5.

105 N D'Angelo, 'The unsecured creditor's perilous path to a trust's assets: Is a safer, more direct US-style route available?' (2010) 84 *Australian Law Journal* 833 at 843.

106 *Lerinda Pty Ltd v Laertes Investments Pty Ltd* (2009) [2009] QSC 251; see also *Bofinger v Kingsway Group Ltd* [2009] HCA 44 at [6].

property of any trust should be available for all creditors of that trustee.[107] Another line of authority is that, in the first instance, those funds should be available only for those creditors who have dealt with the trustee as trustee of that particular trust.[108]

Under the SLE Proposal, the RE would not act as principal in relation to scheme matters. Counterparties would have no right against the personal assets of the RE (unless the counterparties and the RE so agreed or the RE was acting beyond its agency powers and the indoor management rule[109] did not apply). Counterparties would have direct rights against scheme property held by the MIS and would not need to rely on a right of subrogation.

2.2.4 Position of scheme members

Scheme constitutions usually exempt scheme members from any obligation to indemnify the RE for expenses and liabilities that it has incurred in operating the scheme. If not, the RE may have a right of indemnity against those members for those amounts.[110]

The 2012 CAMAC report recommended that there be statutory limited liability for scheme members.[111]

2.3 External controls

The RE of a listed scheme is under a continuing obligation to notify the market of any material price-sensitive information concerning the scheme that is known to the RE but is not generally available.[112]

Disclosure issues are discussed in Chapter 10 of this paper (see also Section 5.7 in relation to disclosure of investment guidelines).

ASIC has a range of powers under Chapter 5C, including to make various exemption and modification orders,[113] to undertake surveillance checks of REs,[114] to require modification

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107 *Re Enhill Pty Ltd* [1983] 1 VR 561.

108 *Re Suco Gold Pty Ltd* (1983) 33 SASR 99. The Harmer Report (vol 1, para 262) summarised the position reflected in *Re Suco Gold* as follows:

> Equitable principles require that a [trustee] company's own property and trust property, or property of two or more trusts, and the respective sets of creditors be kept separate and that each group of creditors be entitled to a distribution of the funds derived from the property in which they could claim an interest.

See also *Re ADM Franchise Pty Ltd* (1983) 7 ACLR 987, which is consistent with the *Suco Gold* approach. Various commentators also support the *Suco Gold* approach: R Baxt, 'Trusts and Creditors Rights' (1982) 11 ATR 3, 9; BH McPherson, 'The Insolvent Trading Trust' in PD Finn (ed), *Essays in Equity* (Law Book Co, Sydney, 1985), 142; and HAJ Ford, 'Trading Trusts and Creditors' Rights' (1981) 13 *Melbourne University Law Review* 1.

109 Under the SLE Proposal, there would be an indoor management rule similar to that for companies (ss 128-129) (see Section 3.3 of the 2012 CAMAC report). Under this rule, a counterparty would be entitled to assume that an RE that discloses that it is acting as agent for a particular MIS is acting within its agency powers and is otherwise complying with the requirements of the scheme, unless the counterparty knew or suspected otherwise (cf s 128(4)).

110 *Fitzwood Pty Ltd v Unique Goal Pty Ltd* [2002] FCAFC 285 at [135]-[138]. See further the CASAC report *Liability of Members of Managed Investment Schemes* (March 2000), available under 'Publications' on the CAMAC website www.camac.gov.au

111 Section 8.4.3. The report recommended that this limited liability should not be subject to any contrary provision in a scheme constitution.

112 Chapter 6CA *Continuous disclosure*. Specific reference to the obligation of the RE is found in s 674(3).

113 Part 5C.11.

114 s 601FF.

of a compliance plan,[115] and to apply to the court to have a TRE appointed[116] or to have a scheme wound up.[117]

ASIC has a range of investigative and other powers, including those pursuant to the licensing regime for the RE[118] and its general information-gathering powers under the ASIC Act.[119] ASIC also has powers to:

- commence proceedings[120]
- apply for a declaration of contravention, a pecuniary penalty or a compensation order for breach of a civil penalty provision[121]
- seek preservative orders, injunctions, and orders affecting contracts or requiring the payment of damages.[122]

ASIC provides regulatory guidance on various aspects of the operation of schemes.[123]

Issues relating to ASIC's regulatory powers are discussed in Chapter 13 of this paper.

2.4 Voluntary administration of a scheme

The ALRC/CASAC report recommended that a voluntary administration (VA) framework for schemes be introduced, similar to that for companies under Part 5.3A.[124] A scheme VA procedure may provide an opportunity to restructure a financially stressed, but potentially viable, scheme, or otherwise provide a better return for scheme creditors than if the scheme was immediately wound up.

Those recommendations were not adopted. Neither the second reading speech for the *Managed Investments Bill 1997* (Cth), which provided for the introduction of Chapter 5C into the Corporations Act, nor the Explanatory Memorandum to that Bill, explained this omission.

Chapter 6 of the 2012 CAMAC report recommended a VA procedure for schemes. It provided details of how such a procedure might be implemented if the SLE Proposal is, and if it is not, adopted. It also discussed various implementation issues that would arise in either case.

2.5 Winding up a scheme

The procedures for the winding up of a scheme that were introduced in 1998 primarily envisage the winding up of solvent schemes, with the RE conducting the winding up, though the court has a power to order a winding up on the 'just and equitable' ground and

115 s 601HE(2).
116 s 601FN.
117 s 601ND. See also s 601NF.
118 See, for instance, ss 912C-912E.
119 Part 3 of the ASIC Act.
120 s 1315(1)(a).
121 s 1317J(1).
122 ss 1323, 1324 and 1325.
123 See, for instance, ASIC Regulatory Guides 132-136 and the best practice unit pricing guide (RG 94).
124 vol 1 at para 8.13 and vol 2 Pt 5.3B.

to 'appoint a person to take responsibility' for the liquidation of a scheme if the court 'thinks it necessary to do so'.[125]

Historically, little consideration was given to the winding up procedures for insolvent schemes, particularly when they were more in the nature of pooled schemes involving securities or other investment portfolios, with no significant creditor involvement. Pooled schemes of this nature were more likely to lose value and be wound up for that reason, rather than be unable to meet the claims of creditors as they became due and payable.

However, the approach in Australia over more recent years, driven in part by taxation considerations and the growth of superannuation funds under management, has been to expand the role of schemes, with some of them becoming significant commercial enterprises in their own right, with external financing or other creditors. There is no detailed procedure in the current law for the winding up of these types of schemes if they become insolvent.

Chapter 7 of the 2012 CAMAC report contained comprehensive recommendations for the winding up of insolvent schemes, as well as some recommendations for the winding up of solvent schemes.

Chapter 12 of this paper discusses some additional issues relating to the winding up of schemes.

[125] Part 5C.9.

3 Definitions

This chapter discusses whether there is any need for modifications to the Corporations Act definitions of 'managed investment scheme', 'member' and 'scheme property'.

3.1 Definition of 'managed investment scheme'

The issue

The definition of managed investment scheme may leave unregulated some arrangements that should be regulated as schemes.

Current position

The core elements of a 'managed investment scheme' are set out in paragraph (a) of the definition in s 9, which covers schemes having the following features:

> (i) people contribute money or money's worth as consideration to acquire rights to benefits produced by the scheme
>
> (ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, *for the people (the members) who hold interests in the scheme* (whether as contributors to the scheme or as people who have acquired interests from holders);
>
> (iii) the members do not have day-to-day control over the operation of the scheme.[126]

This definition was considered in *In Re Lawloan Mortgages Pty Ltd*.[127] In that case, there was a mortgage lending scheme that had various subsets of members. The contributions of the members in each subset were pooled in a trust account for disbursement as loans to borrowers, but there was no broader pooling of funds as between the various loans and the contributions were not capable of producing, and were not intended to produce, any benefit for the larger set of investors in the mortgage lending scheme. It was held that the words '*for the people (the members) who hold interests in the scheme*' in the definition of 'managed investment scheme' require that 'the benefits produced by the pooling of funds in a given scheme must be capable of flowing to all, not a sub-set, of the members in the scheme'. On this basis, the Court held that the loan scheme, in which subsets of investors contributed to separate loans, did not come within the definition of 'managed investment

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126 Paragraph (a) of the definition. There is a series of specified arrangements that do not fall within the definition of 'managed investment scheme': paras (c)-(ma) of the definition. Paragraph (n) provides for the regulations to declare other kinds of scheme not to be a managed investment scheme. There are no relevant regulations.

127 [2002] QSC 302 at [78].

scheme' (though each of the individual loans did come within that definition). The courts in earlier cases dealing with similar facts reached a different conclusion.[128]

Analysis and discussion

The managed investment provisions were introduced in response to a 'need to ensure that there is a proper legal framework' that 'provides an appropriate level of regulation that adequately and effectively protects the interest of investors'.[129] The ALRC/CASAC report observed that:

> 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.[130]

Given this investor protection goal, it would be consistent with the policy objective if the definition of 'managed investment scheme' could ensure that it covers any arrangements where ordinary (especially retail) investors contribute money to collective investment enterprises in the expectation of receiving a benefit.

This goal may not be achieved under the current definition of 'managed investment scheme'. As interpreted in the *Lawloan* decision, that definition only applies where all members benefit from the pooling or common enterprise under the scheme. It will not cover artificial structures that contain a small number of members (even as few as one) who receive no benefit from the scheme. There is therefore the potential for significant numbers of retail investors to become involved in these types of schemes and be left without the protections of the managed investment provisions.

A possible response may be to make clear that, where all the other elements of the definition are satisfied, the definition will include arrangements that provide benefits to at least some members of the scheme. If this approach were to be adopted, ASIC could use its exemption power[131] in circumstances where only very few members would receive a benefit and ASIC is otherwise satisfied that the arrangement does not need to be regulated as a managed investment scheme.

Question 3.1.1. Should arrangements where not all the members of the scheme receive a benefit under the scheme come within the definition of 'managed investment scheme' and, if so, how might the definition best be amended to extend to these arrangements?

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128 *ASIC v Chase Capital Management Pty Ltd* [2001] WASC 27 at [59]-[60], *ASIC v Knightsbridge Managed Funds Ltd* [2001] WASC 339 at [52]-]54]. It should be noted, however, that the Court in the *Lawloan* case (at [79]) drew attention to points of distinction between the circumstances in that case and those in earlier two cases. In the *Chase Capital* case, 'the issue was not whether the individual investments should be characterised as schemes, as opposed to the overall arrangement, but rather whether the arrangements amounted to managed investment schemes at all'. In the *Knightsbridge* case, the money to be advanced under all the loans was placed into a single cash management account that attracted interest on the total funds, which was subsequently shared pro rata among investors.

129 Joint Australian Law Reform Commission (ALRC)/Companies and Securities Advisory Committee (CASAC) report *Collective Investments: Other People's Money* (1993) at p xv (the terms of reference).

130 para 1.4.

131 s 601QA.

Question 3.1.2. Are there any reasons why the definition should not be amended in this way?

3.2 Definition of 'member' of a managed investment scheme

The issue

The range of persons who may be covered by the definition of 'member' of a managed investment scheme may not be sufficiently certain. In particular, it may be beneficial to clarify the position of option holders.

Current position

A 'member' in relation to a managed investment scheme is defined as 'a person who holds an interest in the scheme'.[132] In turn, s 9 defines 'interest in a managed investment scheme' very broadly to mean:

> a right to benefits produced by the scheme (whether the right is actual, prospective or contingent and whether it is enforceable or not).

It has been held that the definition of an 'interest' in a managed investment scheme covers a binding contract for an RE to issue units in a scheme.[133]

In addition, there is authority that interests in a scheme include options enforceable against the RE of a scheme or a person acting on its behalf to take up units in the scheme.[134] Also, the Explanatory Memorandum to the Bill for the *Managed Investments Act 1998* stated:

> An option to subscribe for an interest in a managed investment scheme will be an interest in a managed investment scheme because it is a contingent right to the benefits of the scheme.[135]

There is a regulation that ensures that the holders of these options need only be included on the register of option holders, not also on the register of members.[136]

Analysis and discussion

The Corporations Act should give clear guidance about the circumstances in which a person holds an 'interest' in, and therefore is a 'member' of, a scheme, given that the Corporations Act imposes regulatory requirements in relation to 'interests' and confers rights on 'members'.

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132 Paragraph (a) of the definition of 'member' in s 9.

133 *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd* [2008] NSWSC 766 (see particularly at [100]-[101]).

134 *Seabrook, in the matter of the Takeovers Panel & the Corporations Act 2001 (Cth)* [2002] FCA 1219.

135 para 19.8. See also para 6.79 of the Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001*.

136 Corp Reg 5C.11.03, which provides that:

> The register of members of a registered scheme need not contain information about a member whose only interest in the scheme is as the holder of an option.

The requirement for a register of members is in ss 168(1)(a), 169. The separate requirement for a register of option holders is in ss 168(1)(b), 170.

The Court in *Seabrook, in the matter of the Takeovers Panel & the Corporations Act 2001 (Cth)* [2002] FCA 1219 noted Corp Reg 5C.11.03 (at [19]) and the separate provisions requiring a register of members and a register of option holders (at [24]).

If something constitutes an 'interest' in a scheme, the scheme constitution must make 'adequate provision for the consideration that is to be paid to acquire' that interest.[137] This may be difficult to do where the interest is a prospective or contingent interest that may not be enforceable, rather than an actual interest.

Corporations Act provisions that relate to 'members' of a scheme include:

- a scheme must maintain a register of members[138]
- the scheme constitution must specify any right members have to withdraw from the scheme[139]
- the scheme constitution must be legally enforceable as between members and the RE[140]
- members have a vote on a special resolution to modify, repeal or replace the scheme constitution[141]
- members have the right to recover from the RE the amount of any loss or damage caused to them in their capacity as members by the RE.[142]

One commentary has noted that the breadth of the definition of 'member':

> may create problems for the responsible entity in discharging its administrative functions, such as maintaining the register of members and providing annual reports to members … It may also expand the categories of persons who are "members" for the purposes of calculating voting thresholds, determining entitlement to remedies under s 601MA, and so on. To the extent that the responsible entity cannot know the identity of all those who may have a prospective or contingent interest, whether enforceable or not, in benefits produced by the scheme, it may be difficult as a practical matter to determine the extent and identity of the membership.[143]

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

In contrast with the wide and indeterminate range of persons who may be members of a scheme, a person is only a member of a company if the person agrees to become a member and the person's name is entered on the register of members.[144] Also, a holder of options over unissued shares in a company is not a member of that company.[145]

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137 s 601GA(1)(a). See *Seabrook, in the matter of the Takeovers Panel & the Corporations Act 2001 (Cth)* [2002] FCA 1219 at [19]-[21].

138 s 168(1).

139 s 601GA(4).

140 s 601GB. The question of enforceability of the scheme constitution is further discussed in Section 6.1 of this paper.

141 s 601GC.

142 s 601MA.

143 P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶65-200.

144 s 231. The Court in *Seabrook, in the matter of the Takeovers Panel & the Corporations Act 2001 (Cth)* [2002] FCA 1219 noted (at [23]) that '[T]raditionally in the area of corporate governance, the notion of "holder" in the context of the definition of a shareholder has carried the meaning of "registered holder"' (citing *Dalgety Downs Pastoral Co Pty Ltd v Federal Commissioner of Taxation* (1952) 86 CLR 335 at 341 and *Santos Ltd v Pettingell* (1979) 4 ACLR 110 at 119.

145 HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [17.320].

Adoption of the same approach for schemes would provide greater certainty about who is a member of a scheme. It would also remove the overlap between the categories of members of a scheme and holders of options in a scheme. Furthermore, a definitive register of scheme members would be consistent with the recommendations in the 2012 CAMAC report for definitive registers of agreements relating to a scheme[146] and of the property of a scheme.[147]

There are various situations in which scheme members may be disadvantaged if their scheme membership depended on their inclusion on the register. For instance, a person may not be on the register due to:

- an oversight or system failure in the registry systems
- delay by the RE in registering the acquisition of an interest
- failure by the RE to amend the register for dishonest reasons.

These areas are equally relevant to members of companies. Rectification of the relevant register may provide an adequate solution for members of schemes as well as companies.[148]

However, in other circumstances, removal from the register may cause difficulties for scheme members that would not arise for members of companies.

For instance, ASIC requires that scheme constitutions 'not include provisions that treat withdrawing members as having ceased to be a member before the time for which the scheme property is valued for determining the withdrawal price', as 'until that time the member can share in any increase in the value of scheme property and so retains an interest in the scheme'.[149]

Also, one of the tests for determining whether a scheme should be registered relates to how many members it has (see the discussion of the numerical test in Section 4.1 and Appendix 1 of this paper). If a scheme's members were only those persons on the scheme's register, the requirement to register the scheme could be avoided by failing to complete the register. However, this potential concern could be dealt with by an amendment to the relevant test for registration (if retained), for instance by basing it on 'members or persons who are entitled to be registered as members'.

Consideration might be given to whether there are any rights of scheme members that should be preserved for option holders if the category of scheme members were limited to those on the register of members, for instance, access to a method for dealing with complaints.[150]

Question 3.2.1. Have any problems arisen from the breadth of the definition of 'member' of a managed investment scheme? If so, please give details, including how many schemes and investors may have been affected.

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146 Section 4.3.4.
147 Section 4.4.3.
148 HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [21.060].
149 Regulatory Guide 134 *Managed investments: Constitutions* (February 2014) at RG 134.167.
150 s 601GA(1)(c).

Question 3.2.2. Should the definition of 'member' of a scheme be made more specific, for instance, by providing that a person is a member of a registered scheme only if the person appears on the register of members?
Question 3.2.3. Alternatively, if the current broad definition of 'member' remains, are any amendments required to other Corporations Act provisions to deal with the administrative consequences for the RE of having this wide definition?

Question 3.2.4. Are there any reasons why the current broad definition of 'member' in the Corporations Act should remain as it is or, alternatively, why it should not be changed in a particular manner?

Question 3.2.5. What, if any, specific rights should be preserved for holders of options over unissued interests in a scheme if it is made clear that those option holders are not members of the scheme?

3.3 Definition of 'scheme property'

The issues

The definition of 'scheme property' in the Corporations Act lists specific items that are scheme property. However, the definition may not cover all categories of property that might reasonably be included in this concept.

A separate but related issue is that it is not always clear when property ceases to be scheme property.

Current position

Section 9 contains a definition of scheme property, being:

(a) contributions of money or money's worth to the scheme; and

(b) money that forms part of the scheme property under provisions of this Act[151] or the ASIC Act; and

(c) money borrowed or raised by the responsible entity for the purposes of the scheme; and

(d) property acquired, directly or indirectly, with, or with the proceeds of, contributions or money referred to in paragraph (a), (b) or (c); and

(e) income and property derived, directly or indirectly, from contributions, money or property referred to in paragraph (a), (b), (c) or (d).

The definition does not indicate when property ceases to be scheme property.

Analysis and discussion

It is important for an RE to know what property is 'scheme property' for the purposes of:

- the duty to ensure that scheme property is clearly identified as such and held separately from the RE's property and that of any other scheme[152]

[151] See, for instance, s 601FB(4).

- the duty to ensure that the scheme property is valued at regular intervals appropriate to the nature of the property[153]

- the duty to ensure that all payments out of the scheme property are made in accordance with the scheme's constitution and the Corporations Act.[154]

Other matters that depend on the accurate identification of scheme property include:

- the valuation of scheme property for the purpose of determining whether a scheme is liquid[155]

- whether the provisions governing the giving of financial benefits out of scheme property to related parties apply.[156]

Furthermore, the 2012 CAMAC report recommended that scheme constitutions include an obligation for the RE to maintain a register of scheme property, reinforced by the licensing obligations and legislative sanctions for any breach.[157]

The current definition of scheme property focuses on three categories of property:

- contributions by members to the scheme

- money that the Corporations Act or the ASIC Act stipulates is scheme property

- money that the RE borrows or raises for the purposes of the scheme.

Property or income arising directly or indirectly from these categories of money is also scheme property.

Certain property that might reasonably be considered to be scheme property may arguably not come within any of these existing categories, for instance:

- amounts that an RE decides to pay into the assets of the scheme to compensate for losses due to breaches by the RE (even though not required to do so by a court order[158])

- contributions for the payment of rent in relation to land on which the scheme is operated, where those payments have been retained by the RE pending later payment to the lessor when they fall due. These may not be contributions 'to the scheme' as required by paragraph (a) of the definition, as they are held for payment to an outside party, the lessor of land

- money that has been paid to acquire a new interest in a scheme and is required to be held in a separate account pending the transfer of the interests to the acquirer.[159] This

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152 s 601FC(1)(i). The scheme's compliance plan must deal with this matter: s 601HA(1)(a).
153 s 601FC(1)(j). The scheme's compliance plan must deal with this matter: s 601HA(1)(c).
154 s 601FC(1)(k).
155 s 601KA(4). The test for determining whether a scheme is liquid is discussed in this paper at Section 9.3.
156 ss 601LB, 601LC.
157 Section 4.4.3.
158 The legislation already provides that compensation paid into a registered scheme by the RE pursuant to a court order is transferred to scheme property: s 1317H(4).

money may not constitute contributions 'to the scheme' as required by paragraph (a) of the definition, as it is held in a separate account for persons who are not yet scheme members

- application fees from prospective borrowers from a mortgage scheme. These payments do not fall readily within any of the existing categories of scheme property.

One approach would be to make specific amendments to the definition of 'scheme property' in section 9 to ensure that it covers these categories of property. This approach would require further amendments to the definition each time there was a doubt about whether a particular further category of property fell within the definition of 'scheme property'. Any need for ongoing amendments may be more readily met if the definition of 'scheme property' allowed for additional categories to be prescribed in the regulations.

An alternative approach would be to provide a more general definition, to the effect that scheme property is property that is held by the RE or its agents or employees (or, under the SLE Proposal, by the MIS[160]) in relation to the scheme. This approach would avoid the need for piecemeal amendment of the definition to cover additional categories of property.

A general definition along these lines would also respond to a concern identified by the Turnbull Report, which recommended that the definition of scheme property be amended to clarify when property ceases to be scheme property.[161] That report referred to a suggestion by ASIC that property should cease to be scheme property:

- when it is paid to scheme members
- when it is paid to the RE as a fee or indemnity[162]
- where it is no longer held by the RE or its agents or appointees, unless a constructive trust arises.[163]

Consideration may need to be given to whether any general definition should also include property that, while it is not held by the RE, nevertheless relates to the scheme and is held on a constructive trust for the RE. A possible way of achieving this result might be to provide that scheme property is property that is held by *or on behalf of* the RE or its agents or employees (or, under the SLE Proposal, by *or on behalf of* the MIS) in relation to the scheme.

Consideration may also need to be given to whether a general definition of scheme property should exclude property held by the RE in relation to the scheme, but nevertheless properly regarded as its personal property rather than scheme property (for instance, capital that it must hold pursuant to ASIC's licensing requirements[164]). It has

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159 s 1017E. Clarification that this money is scheme property would make it clearer that the operation of the account is part of the operation of the registered scheme and should therefore be dealt with in the compliance plan. An alternative way of ensuring this result would be an explicit requirement that the compliance plan deal with compliance with s 1017E and that the operation of the s 1017E account in relation to a particular registered scheme is part of the operation of that scheme.

160 The SLE Proposal is summarised in Section 1.1.1 of this paper.

161 Section 5.2.4 and rec 17.

162 The RE's rights to be paid fees out of scheme property, or to be indemnified out of scheme property, must be specified in the scheme's constitution (s 601GA(2)).

163 Section 5.2.4. The Turnbull Report said that situations in which a constructive trust is taken to arise may require some specification.

164 RG 166 *Licensing: Financial requirements* (November 2013).

been held that this type of property does not fall within the current definition of scheme property.[165]

Question 3.3.1. Have any problems arisen from the current definition of 'scheme property'? If so, please give details, including how many schemes may be affected.

Question 3.3.2. Should the legislation be amended to provide a more comprehensive definition of 'scheme property' and, if so, should specific categories of property be added to the current definition or should that definition be replaced with a more general definition?

Question 3.3.3. If specific categories are added to the definition, what should those additional categories be?

Question 3.3.4. If a more general definition is preferred, what should that definition be?

Question 3.3.5. If a more general definition is preferred:

- does it need to deal with the situation where property in relation to the scheme is held on constructive trust for the RE
- should it exclude property relating to the scheme that is property of the RE in its own right?

Question 3.3.6. If specific categories are added to the definition, should the Corporations Act clarify the circumstances in which property ceases to be scheme property and, if so, how?

Question 3.3.7. If a general definition is adopted, would that definition make it sufficiently clear when property ceases to be scheme property?

Question 3.3.8. Are there any reasons why there should not be a broader definition of scheme property or, alternatively, why further specific categories of scheme property should not be added to the current definition?

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[165] In *Re Gunns Plantations Limited (No 4)* [2013] VSC 595, the RE took out a bank guarantee (the RE Guarantee) to ensure that it would be able to pay all its debts as and when they become due and payable. The Court held that the RE Guarantee did not fall within the definition of 'scheme property'. In support of that conclusion, it said (at [28]):

> The RE Guarantee made no reference to the schemes, nor was it a requirement under any of the scheme constitutions or other scheme documents for [the RE] to obtain the RE guarantee. The RE Guarantee was not an essential element of the schemes. Rather, it was a mechanism by which [the RE] could satisfy the regulatory requirement placed upon it by its AFSL to remain solvent. That of itself cannot be categorised as a contribution to the schemes. Nor is it money raised by [the RE] for the schemes.

4 Scheme registration

This chapter discusses the circumstances in which a managed investment scheme must be registered and ASIC's role in the registration process.

4.1 Criteria for determining whether a scheme should be registered

The issue

Should all managed investment schemes be registered? If not, what types of scheme should not be registered?

Current position

A managed investment scheme must be registered if:

- it (by itself or together with other closely related schemes as determined by ASIC) involves more than 20 investors (the numerical test),[166] and/or
- it was promoted by a person, or an associate of a person, who was in the business of promoting managed investment schemes at the time the scheme was promoted (the professional promoter test).[167]

A scheme that satisfies either or both of these tests is nevertheless exempt from the requirement to be registered if none of the issues of interests in the scheme would have activated the Product Disclosure Statement (PDS) requirements in Division 2 of Part 7.9 of the Corporations Act[168] (the disclosure test).

Appendix 1 to this paper provides more detailed information about:

- the professional promoter test and the disclosure test
- various matters raised in the **Analysis and discussion** part of this section.

Analysis and discussion

Purpose of registration

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

In the case of registration, there is a key difference between companies and schemes.

Those involved in the formation of a company choose to incorporate, usually to obtain the benefit of limited liability. Registration of a company by ASIC under the Corporations

166 s 601ED(1)(a), (c), (3).
167 s 601ED(1)(b).
168 s 601ED(2), Corp Reg 5C.11.05A.

Act[169] brings the company into existence[170] and that Act provides the company with the legal capacity and powers of an individual and all the powers of a body corporate.[171] Registration as a company, in turn, brings the company within the regulatory requirements of the Corporations Act.

By contrast, schemes exist by virtue of contractual arrangements between private parties, without the need for any statutory authorisation. The sole purpose of the registration requirement for schemes is to bring them within the purview of the regulatory requirements of the Corporations Act. The ALRC/CASAC report said that schemes should 'be clearly identifiable for regulatory and general information purposes'.[172] One commentary has observed that:

> the legislation is concerned only with those offerings of investment opportunities which are so similar to offerings of shares and debentures that regulation about them calls for regulatory techniques that developed in relation to offerings of shares and debentures.[173]

Regulatory requirements of the Corporations Act to which registered schemes are subject include:

- the requirements in the schemes provisions of Chapter 5C of the Corporations Act, for instance:
  - the requirement to have a responsible entity (discussed in Section 5.2.1 of this paper).[174] The RE must hold an Australian financial services licence and is therefore subject to various licensee obligations, including the requirement to have adequate risk management systems (discussed in Section 5.4 of this paper)
  - the compliance framework (discussed in Section 5.3 of this paper)
- requirements applicable to companies as well as registered schemes, such as the financial reporting and record-keeping requirements (see Section 5.2.5 of this paper).

Given that schemes, unlike companies, do not need registration for their existence, it may be appropriate to allow some schemes to remain unregistered where regulation under the Corporations Act may not be necessary, as discussed below under the heading ***Numerical test***. As a broad proposition, however, CAMAC considers that schemes should generally be subject to the regulatory requirements of the Corporations Act. CAMAC therefore favours abolition of the disclosure test for exemption, for the reasons discussed below.

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169 Chapter 2A.

170 s 119. Company registrations that were in force under the Corporations Law of the States and Territories immediately before the commencement of the Corporations Act continue as if they were registrations under the Corporations Act (s 1378, definition of 'old Corporations Law' in s 1371).

171 s 124.

172 ALRC/CASAC report para 4.9. Also, the Court in *Australian Securities and Investments Commission v Koala Quality Produce Ltd* (2002) 41 ACSR 628 at 629 at [5] observed:

> ... registration and the protections it involves are deemed by the law to be necessary in the interests of investors. Without registration and the regime it entails, necessary controls are lacking, with the result that investors are exposed to a situation in which their funds are not protected in the way the legislation intends them to be protected.

See also *ASIC v Young* [2003] QSC 29 at [67], *ASIC v Chase Capital Management Pty Ltd* [2001] WASC 27 at [88].

173 HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.470.3]. As noted in that commentary, this passage was approved by Sundberg and Dowsett JJ in *Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd* [2009] FCAFC 147 at [24].

174 s 601EB(1)(d).

Numerical test

The definition of 'managed investment scheme'[175] is very broad, catching a wide range of arrangements, potentially including private arrangements between small groups of friends and family members. There may be no policy rationale for subjecting these arrangements to the various regulatory requirements that apply to registered schemes.

The numerical test for registration provides a means of excluding these arrangements from regulation under the Corporations Act.

Professional promoter test

A numerical threshold requires a complementary test, such as the professional promoter test, to guard against the possibility of a person setting up a series of schemes, all falling below the stipulated threshold, to avoid the need to register them. However, there are some difficulties in applying the professional promoter test, for instance in determining:

- who is the 'promoter' of a scheme (where an organization initiates a scheme, is the promoter the organization or the RE, or are they both promoters?)
- when a person is in 'the business of promoting managed investment schemes'.

Possible ways to clarify what constitutes the business of promoting managed investment schemes include:

- the inclusion of a specific test (for instance, the person has promoted schemes that have in total at least a certain number of members at the time the offer for the relevant scheme occurs or have raised a minimum amount)
- the application of a more generic test (for instance, the person is forming the scheme with a view to profit other than as a member of the scheme[176]).

Disclosure test

Abolition of the test

In CAMAC's view, the disclosure test should be abolished: the criteria for deciding whether a scheme should be registered should not be linked to those for deciding whether an issue of interests in a scheme requires disclosure. The policy reasons for the current disclosure test have not been clearly articulated. Exemptions from the disclosure requirements for scheme interests should be dealt with separately from the criteria for registration.

Wholesale schemes

One category of schemes that would be exempt from registration under the disclosure test is schemes that involve only wholesale investors.[177] One commentary nominates the exemption of wholesale schemes as the purpose of the disclosure test.[178]

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175 Definition of 'managed investment scheme' in s 9. An issue arising from this definition is discussed in Section 3.1 of this paper.

176 cf *ASIC v Chase Capital Management Pty Ltd* [2001] WASC 27 at [61] and *ASIC v Young* [2003] QSC 29 at [54].

177 The PDS requirements for issues only apply in relation to issues, or issue offers, that involve retail clients: s 1012B.

178 P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶1-500 (see also at ¶10-340).

CAMAC questions whether wholesale schemes should be exempt from registration. The policy rationale for such an exemption may have been that wholesale investors do not need the same investor protection as retail investors. However, CAMAC can see no reason why wholesale schemes should not be subject to the regulatory provisions of the Corporations Act in the same manner as companies that may only have wholesale investors.

Also, in many instances, significant amounts of funds invested by retail investors are channelled into wholesale-only schemes through institutional investors. Furthermore, increased wholesale regulation may better reflect international regulatory standards.[179]

If some Corporations Act requirements were thought to be over-regulatory for wholesale-only schemes, consideration might be given to exempting those schemes from particular requirements on a case-by-case basis or creating a separate class of wholesale-only schemes, subject to more limited requirements than schemes generally.

Even if it were accepted that there should be no requirement to register wholesale-only schemes, the current disclosure test may exempt from registration some schemes that directly involve retail investors, given that the test refers only to 'issues' of interests, and does not cover 'sales' of interests, in a scheme. Appendix 1 to this paper explains in more detail why this is the case.

Application to small schemes

The interaction of the disclosure test with the numerical test and the professional promoter test leaves doubt about the preferred policy approach to small schemes. If a scheme satisfies the professional promoter test, it must be registered (unless an exception applies), even if the scheme has 20 or fewer members and would therefore not require registration under the numerical test if that test applied by itself. However, the disclosure test, by applying the small-scale offerings disclosure exemption,[180] exempts schemes with 20 or fewer members from registration, even if the scheme satisfies the professional promoter test.[181]

Increase in the scope of the disclosure test

While the exceptions from the disclosure requirements principally covered wholesale and private schemes when the managed investment provisions were first introduced, they now include other matters that are not appropriate criteria for deciding whether to register a scheme. There is no evidence that the consequences for the scheme registration criteria

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179 For instance, in relation to financial reporting, Principle 28 of the IOSCO *Objectives and Principles of Securities Regulation* (2010) states:

> Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.

IOSCO, in its *Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (2011), states (at 173 in the Explanatory Notes to Principle 28) that:

> Assessors should consider whether the standards for internal organization and operational conduct to be observed on an on-going basis by the hedge fund manager/advisers (in view of the risks posed) take into account at least … independent audit on an annual basis of the financial statements of the fund manager/adviser and/or each of the funds managed.

The IOSCO *Methodology* also states (at 174) that:

> hedge fund managers/advisers or the hedge fund should provide proper disclosure to investors … including audited financial statements of the hedge fund manager/adviser and/or the fund managed.

These standards relate to hedge funds generally, not just those offered to retail investors.

180 s 1012E.

181 The numerical test requires registration if the scheme 'has more than 20 members' (s 601ED(1)(a)). The small-scale offering exception applies, inter alia, when no more than 20 persons purchase interests in any 12 month period (s 1012E(2)(b), (6), (7)).

were taken into account when the disclosure requirements were being amended. Appendix 1 to this paper discusses these matters in more detail.

Question 4.1.1. Should all schemes require registration? If not, what should be the criteria for exemption from registration (for instance, should the numerical test be retained in its current form or with a higher or lower numerical threshold)?

Question 4.1.2. If an exemption from registration along the lines of the professional promoter test is retained, does the test require amendment? If so, how should it be amended?

Question 4.1.3. Does special provision need to be made for wholesale-only schemes and, if so, what? For instance, should there be a separate class of registered scheme for wholesale-only schemes or, alternatively, should wholesale-only schemes be exempt from regulatory requirements and, if so, what requirements and why?

4.2 ASIC's role in scheme registration

The issues

Should ASIC's role in scheme registration be more closely aligned with its role in company registration?

Current position

Application to ASIC

The company registration procedure and the scheme registration procedure both commence with the lodgement of an application with ASIC.[182]

Contents of the application

Details about key participants

The application must set out details of the key participants in the company or scheme.

In the case of a company, the required details are:

- the names and addresses of its members
- the present and any former names, the address and the date and place of birth of each person who has consented in writing to become a director or company secretary
- for a company limited by shares and an unlimited company, details about each member's shareholding and for a company limited by guarantee the proposed amount of the guarantee to which each member agrees.[183]

In the case of a scheme, the required details are:

- the name, and the address of the registered office, of the RE

[182] ss 117(1) (companies), 601EA(1) (schemes).
[183] s 117(2)(c)-(f), (k), (m), (5), ASIC Form 208.

- the name and address of a person who has consented to be the auditor of the compliance plan.[184]

Given that the RE must be a public company,[185] details of its directors and company secretary will have been provided to ASIC in the RE's application for registration as a company or in subsequent notifications to ASIC if there is a later change.

The application for registration as a scheme does not need to include details of the persons who propose to be members of the scheme. This may reflect the notion of a scheme as a passive investment vehicle, as opposed to the view of a limited liability corporate structure as a vehicle for entrepreneurial risk-taking.[186]

Applicants to register a company or a scheme must have relevant consents and agreements when the application is lodged. After registration, the consents and agreements must be kept by the company or RE.[187]

Details about the entity

The application must set out key details about the company or scheme. These details differ between schemes and companies, given the structural and regulatory differences.

In the case of a company, the required details are:

- the type of company to be registered
- the company's proposed name (unless the ACN is to be used in its name)
- the address of the company's registered office and, if different, the address of its principal place of business
- for a company limited by shares and an unlimited company, details about shares issued for non-cash consideration
- details of any holding company structure
- the State or Territory in which the company is to be taken to be registered.[188]

If the company is to be a public company and is to have a constitution on registration, a copy of the constitution must be lodged with the application.[189]

In the case of schemes, the application must state the name of the scheme[190] and the following key documents must be lodged with the application:

- a copy of the scheme's constitution
- a copy of the scheme's compliance plan

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184 s 601EA(2).
185 s 601FA.
186 A company must have at least one member (s 114). Single member proprietary companies were introduced by the *First Corporate Law Simplification Act 1995*.
187 ss 117(5) (companies), 601EA(3) (schemes).
188 s 117(2)(a), (b), (g), (j), (l), (ma)-(n), ASIC Form 208. The application must also state the proposed opening hours of the company's registered office if they are not the standard opening hours (s 117(2)(h), definition of 'standard opening hours' in s 9).
189 s 117(3).
190 Corp Reg 5C.1.01.

- a statement signed by the directors of the proposed RE that the scheme's constitution and the scheme's compliance plan comply with the relevant regulatory requirements.[191]

ASIC's role in the registration process

Discretion or obligation

ASIC's role in registering a scheme differs from its role in registering a company.

ASIC has a discretion to grant or refuse an application for company registration.[192] The Explanatory Memorandum to the Bill for the *Company Law Review Act 1998* stated:

> If a proposed company would, when registered, be in breach of another provision of the Law (for example, by having a disqualified director), [ASIC] may exercise its discretion to refuse registration. However, it is not envisaged that [ASIC] will ordinarily attempt to verify the information contained in applications or otherwise investigate whether the Law is being complied with before registering a company.[193]

In practice, therefore, a company will generally be registered as a matter of course unless there is an obvious defect in the application for registration.

By contrast, ASIC must register a scheme within 14 days of lodgement of the application for registration, unless it appears to ASIC that the application or the proposed scheme is deficient in one or more of the following respects:

- the application does not supply the required details and documents[194]
- the proposed RE is not a public company that holds an Australian financial services licence[195]
- the scheme's constitution does not meet the statutory requirements[196]
- the scheme's compliance plan does not meet the statutory requirements[197]
- the copy of the compliance plan lodged with the application is not signed by all directors of the proposed RE[198]
- there are no arrangements that will satisfy the requirements for an annual audit of the compliance plan.[199]

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191 s 601EA(4). The constitution must comply with ss 601GA and 601GB. The compliance plan must comply with s 601HA. Section 601HC requires that the copy of the compliance plan lodged with the application be signed by the directors of the RE.

192 s 118. See *Austin & Black's Annotations to the Corporations Act* at [2A.118].

193 para 7.17.

194 ss 601EB(1)(c), 601EA.

195 ss 601EB(1)(d), 601FA.

196 ss 601EB(1)(e), 601GA, 601GB. ASIC Regulatory Guide 134 gives guidance on the requirements in ss 601GA and 601GB.

197 ss 601EB(1)(f), 601HA.

198 ss 601EB(1)(g), 601HC.

199 ss 601EB(1)(h), 601HG.

It is unclear whether this requirement:

- requires ASIC to give active consideration to each of the elements entitling it to refuse to register a scheme before deciding whether to grant an application (this is ASIC's view of the requirement[200])
- requires ASIC to register the scheme unless it happens to be aware of one of the specified factors that would justify the rejection of a registration application, but without requiring ASIC to give specific consideration to each of those factors.[201]

The statutory language also leaves unclear whether ASIC has an obligation not to register a scheme if it is aware that one of the specified elements exists.

Furthermore, this legislative framework for scheme registration, unlike the framework for company registration, appears to leave ASIC with no discretion to refuse to register a scheme that satisfies the specified criteria but nevertheless would involve a breach of the law (for instance, where a director of the RE is disqualified from acting as a director).

Whatever view of the law is taken on these matters, ASIC is not required to assess the commercial merits of a scheme.

Name of the company or scheme

In addition to the above grounds for refusing to register a scheme, ASIC must not register a scheme if its proposed name is the 'same' as that of an existing scheme or a scheme that has already applied for registration.[202]

In a similar vein, a name is available to a company unless the name is 'identical' to a name reserved or registered for another body.[203]

However, the ground for refusing to register a scheme on the basis of its name is narrower than the equivalent ground for refusing to register a company in the following respects:

- for schemes, the name must be exactly the same to justify a refusal to register whereas, for companies, two names can be considered identical, notwithstanding that they may differ in certain minor respects[204]
- ASIC can refuse registration of a company name on the basis that it is 'unacceptable' on various grounds, including that it is likely to be offensive or that it falsely implies certain governmental or other connections.[205]

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200 See, for instance, ASIC Regulatory Guide 132 *Managed investments: Compliance plans* at RG132.14. See also Auditing and Assurance Board Guidance Statement GS 013 *Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes*, para 6.

201 This view may be supported by HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.501.9], which states that ASIC has a statutory duty to register a scheme, but that there is no statutory duty where it appears that one of the identified factors exists.

202 Corp Regs 5C.1.01(3), 5C.11.04. This regulation provides that the name of a scheme that is applying for registration must not be the same as the name of an existing scheme or a scheme that has already applied for registration. By necessary implication, this requires ASIC to refuse registration if a proposed scheme name and an existing scheme name are identical.

203 s 147.

204 s 147(1)(a), (b), Corp Reg 2B.6.01(1), Item 6101 of Schedule 6 to the Corporations Regulations. The differences to be disregarded include minor grammatical and orthographic variations and situations involving the use by one company of an abbreviated form of the name of another company (for instance, 'Co' for 'Company').

205 s 147(1)(c), Corp Reg 2B.6.01(2), Part 2 of Schedule 6 to the Corporations Regulations.

ASIC cannot refuse to register a scheme name on the basis that the name may mislead investors. If ASIC sees a need to take action where a scheme has a misleading name, it may need to rely on the provisions prohibiting false or misleading statements in relation to financial products[206] and misleading or deceptive conduct in relation to a financial product or financial services.[207]

Consequences of an ASIC refusal to register a scheme

A person who operates a scheme that is required to be registered, but that ASIC has refused registration, would contravene the Corporations Act[208] and the scheme could be wound up by the court.[209]

Analysis and discussion

Alignment with companies

The key practical difference between the company registration process and the scheme registration process is that the legislative registration requirement for schemes has led to ASIC giving more active consideration to the scheme registration criteria than it does to the company registration criteria. Even technical non-compliance with the scheme registration criteria requires changes to documentation or arrangements before a scheme can be registered.

This difference reflects the investor protection elements of the scheme structure, being the scheme constitution and the compliance plan. Registration helps to ensure that a scheme has these features.[210]

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently. It may be possible to bring the scheme registration procedure more closely into line with the corporate procedure (thereby giving ASIC more administrative flexibility), while retaining the investor protection purpose of scheme registration, by:

- permitting registration of a scheme upon lodgement of an application for registration, without the need for detailed consideration of the registration criteria
- ensuring that ASIC has the power to make a stop order, on an interim as well as on a final basis, to prevent any issue of interests in a materially non-compliant scheme.[211]

This procedure would remove the need for ASIC to give active consideration in every case to whether the relevant registration criteria[212] have been satisfied. This approach would be in line with ASIC's role in relation to amendments to the scheme constitution[213] and

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206 s 1041E.
207 s 1041H. This provision imposes civil liability only.
208 s 601ED(5).
209 s 601EE.
210 *Australian Securities and Investments Commission v Koala Quality Produce Ltd* (2002) 41 ACSR 628 at 629 at [5].
211 This power would be along the lines of ASIC's stop order power in s 1020E.
212 s 601EB.
213 s 601GC(2).

amendments to the compliance plan:[214] copies of the relevant amendments are lodged with ASIC, but ASIC has no obligation to reach a view on each amendment lodged with it.

In relation to ASIC's power to refuse registration on the basis of a proposed name, there is no apparent reason why ASIC's power to refuse to register a scheme on this ground should be any narrower than its equivalent power to refuse to register a company.

Possible additional grounds to refuse to register a scheme

Consideration might be given to whether certain features of schemes might justify providing additional statutory grounds on which ASIC could refuse to register a scheme. For instance, schemes frequently involve limitations on the types of investment that the relevant RE can make and on the powers of the RE.[215] By contrast, the Corporations Act provides companies with the legal capacity and powers of an individual and all the powers of a body corporate.[216]

Possible additional grounds on the basis of which ASIC might refuse to register a scheme and that may assist it in performing its investor protection role in relation to schemes include:

- the proposed scheme's name may mislead investors (for instance, where the name gives the impression that the RE's investment powers relate to a more limited class of products than is in fact the case)
- circumstances exist in relation to the scheme that create an inappropriate risk that the scheme will not be operated efficiently, honestly and fairly.

One example of the potential for a scheme name to mislead investors relates to a subcategory of money market funds called 'enhanced' money market funds.

Most money market funds invest in a diversified portfolio of high-quality, short-term money market instruments.[217] By contrast, 'enhanced' money market funds have longer maturity, less liquidity and higher interest rate, credit and liquidity risks than other money market funds.[218] Despite this, an ASIC survey revealed that:

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214 s 601HE(3).

215 The investment powers of the RE must be adequately provided for in the scheme constitution (s 601GA(1)(b)). Those powers are often very wide. However, REs are generally limited in the types of investment they can make by conditions imposed on their licence by ASIC pursuant to s 914A.

216 s 124.

217 ASIC Report 324 *Money market funds* (December 2012) para 2. An ASIC survey revealed that 'on average, 72% of the assets of money market funds were invested in cash instruments, with the remainder in assets such as mortgages and fixed incomes' (id at para 60).
The ASIC Report (at para 26) reported that the money market industry globally represented approximately US$4.7 trillion in assets under management in the first quarter of 2012, and around one fifth of the assets of collective investment schemes worldwide. In relation to the Australian industry, it said (at para 52):

> According to the Australian Bureau of Statistics, in June 2012 the managed funds industry had $1,886 billion funds under management (FUM) and money market funds had, on an unconsolidated basis, a total of $24.4 billion FUM. By these figures, money market funds account for 1.3% of the total managed funds industry in Australia. In March 2012, the global money market fund industry was estimated to be $4.7 trillion. On that basis, Australian money market funds are estimated to account for less than 1% of the global money market fund industry.

218 ASIC Report 324 *Money market funds* at paras 61, 69, 71. On average, 48% of their assets are in cash and often more than 50% of their funds under management are in fixed income instruments and mortgages (id at para 61). The lower liquidity of enhanced money market funds is also noted at paras 74, 110.

> The product branding and PDSs of enhanced money market funds often contain the words 'cash' or 'money market fund'. These funds could be confused with other money market funds by retail investors.[219]

ASIC has said that it is looking to encourage better differentiation between enhanced money market funds and other money market funds.[220]

Any ASIC power to refuse to register a scheme where it believes that the scheme's name is misleading could be complemented by:

- a power for ASIC to refuse to amend the register in case of a notification of change of name[221] where it believes that the proposed name may be misleading
- a power for ASIC to issue a direction to change the name of a scheme if it considers it to be misleading.

Action to deal with misleading scheme names would be consistent with the approach recommended by the International Organization of Securities Commissions (IOSCO) in relation to money market funds.[222]

Moreover, ASIC could be given an express power to require schemes that fall within a particular class to have particular terms in their name. For instance, this power would enable ASIC to require that hedge funds be named as such.

A wider power for ASIC to refuse a scheme registration if circumstances exist in relation to the scheme that create an inappropriate risk that the scheme would not be operated 'efficiently, honestly and fairly' would permit ASIC to assess the prospects for the efficient, honest and fair conduct of a scheme in two different contexts. ASIC, in effect, considers whether a prospective RE would carry out its obligations 'efficiently, honestly and fairly' when deciding its application for an Australian financial services licence.[223] If an 'efficiently, honestly and fairly' criterion were added to the scheme registration criteria, ASIC would again take these factors into account when considering each application for registration of a scheme to be conducted by the RE.

Question 4.2.1. Should ASIC's role in relation to scheme registration be brought more closely into line with its role in relation to company registration by:

- permitting it to register schemes without requiring active consideration of the registration criteria in each case, but giving it stop order powers to prevent the operation of non-compliant schemes
- giving it the same powers to refuse registration on the basis of name or a potential breach of the law as it has in relation to companies?

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219 id at para 70. That report also noted (at para 58) the 'distinct differences between money market funds and fixed income funds in terms of targeted return, risk profile and investment timeframe', as well as the use of 'cash' or 'money market fund' in the product branding of money market funds.

220 id at paras 64, 70, 104, 135–136.

221 Corp Reg 5C.01.02.

222 In its *Policy Recommendations for Money Market Funds Final Report* (October 2012), IOSCO recommends that regulators 'should closely monitor the development and use of other vehicles similar to money market funds (collective investment schemes or other types of securities)' (rec 3) and says, in its commentary on this recommendation, 'when describing [collective investment] schemes as money market funds would be misleading, the reference in product documentation to terminology similar to "money markets" or "cash" should be avoided'.

223 s 913B(1)(b), in combination with s 912A(1)(a).

Question 4.2.2. Should ASIC have the power to refuse to register a scheme if it considers that the scheme's name may mislead investors? If so, should ASIC also have:

- a power to refuse to amend the register in the case of a notification of change of name where it believes that the proposed name may be misleading
- a power to issue a direction to change the name of a scheme if it considers it to be misleading?

Question 4.2.3. Should ASIC have a power to refuse to register a scheme if circumstances exist in relation to the scheme that create a potential risk that the affairs of the scheme would not be conducted 'efficiently, honestly and fairly'?

Question 4.2.4. Should ASIC have a power to require schemes that fall within a particular class to have specific terms in their name?

Question 4.2.5. Are there any other grounds on which ASIC should be permitted to refuse to register a scheme?

5 Governance framework for schemes

This chapter discusses possible ways to improve the governance framework for schemes, including by the introduction of a risk management requirement specifically for schemes. It also examines the role of investment guidelines in the governance framework.

5.1 Overview of the chapter

This chapter considers whether the governance framework for schemes is satisfactory from the point of view of investor protection.

Section 5.2 gives an overview of the current framework, while Sections 5.3 and 5.4 give greater detail about its main structural elements, the compliance regime[224] and the obligation for an RE to have a risk management system for its business (which includes the scheme or schemes that it operates).[225]

Section 5.5 assesses the current framework, including how it compares with the governance framework for companies. Section 5.6 explores options for dealing with possible deficiencies in the framework for schemes, including by giving greater weight to risk management in scheme governance.

Section 5.7 discusses the role that investment guidelines might play in any enhanced risk management system.

5.2 Overview of the governance framework for schemes

5.2.1 The responsible entity

A managed investment scheme must have an RE, which operates the scheme.[226]

The RE, its officers and its employees have various duties under Chapter 5C, as well as under other parts of the Corporations Act and at general law. In addition, the RE is subject to the financial services licensing regime, given that it must be a public company that holds an Australian financial services licence (AFSL) permitting it to operate the scheme.[227]

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224 Parts 5C.4 and 5C.5.

225 A registered scheme must have a risk management system, given that the RE must hold an Australian financial services licence (s 601FA) and a licensee must have adequate risk management systems: s 912A(1)(h).

226 s 601FB(1). One of the key initiatives recommended in the ALRC/CASAC report, and implemented in Chapter 5C, was the introduction of a single licensed RE to operate the scheme and hold scheme property on trust for scheme members. The RE replaced the previous two-tiered trustee and management company structure for the operation of these schemes.

227 s 601FA. See also the definitions of 'financial service' and 'financial services business' in s 761A, ss 766A(1)(d), 911A.

Duties

Duties under Chapter 5C

The RE and its officers and employees have a variety of duties under Chapter 5C, as set out below.[228]

The RE and its officers have duties in relation to a scheme that are analogous to those of the officers of a company, namely:

- to act honestly[229]
- to exercise the degree of care and diligence that a reasonable person would exercise in the RE's or officer's position.[230]

The RE, its officers and its employees also have a duty, analogous to that for the officers and employees of a company, not to make use of information acquired through being the RE, or an officer or employee of the RE, in order to gain an improper advantage for the RE, one of its officers or employees or any other person or to cause detriment to the members of the scheme.[231] There is a similar duty, again analogous to a duty of the officers and employees of a company, for officers and employees of an RE not to make improper use of their positions as officers or employees of the RE.[232]

There are also duties that have no direct equivalent for companies.

The RE and its officers have a duty to act in the best interests of the scheme members and, if there is a conflict between the members' interests and the RE's interests, to give priority to the members' interests.[233] This duty encompasses a 'fundamental duty of undivided loyalty' to scheme members.[234] In addition to the requirement to prefer members' interests if there is a conflict between those interests and the interests of the RE, this duty of undivided loyalty can involve duties for the RE and its officers:

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228 The duties in Chapter 5C reflect the recommendations in the ALRC/CASAC report in relation to the RE (referred to in that report as the 'scheme operator') and its officers (see the discussion at paras 10.3-10.22 of that report).

229 ss 601FC(1)(a) (the RE), 601FD(1)(a) (the RE's officers). See ALRC/CASAC report paras 10.7, 10.18. The equivalent duty for directors and other officers of companies in s 181(1) is to act 'in good faith in the best interests of the corporation and for a proper purpose': the wording of the managed investment scheme provisions reflects the duty applicable to companies when Chapter 5C was introduced (former s 232(2)). For the problems that led to the change in the wording of the provision applicable to companies, see HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [8.065.6].

230 ss 601FC(1)(b) (the RE), 601FD(1)(b) (the RE's officers): cf s 180 for companies. See ALRC/CASAC report para 10.19 (that report only proposed this duty for the officers of the RE, not the RE itself). The s 601FD(1)(b) duty for the RE's officers is discussed in *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [532]-[543].

231 ss 601FC(1)(e) (the RE), 601FD(1)(d) (the RE's officers), 601FE(1)(a) (the RE's employees): cf s 183 for companies. See ALRC/CASAC report paras 10.13, 10.21.

232 ss 601FD(1)(e) (the RE's officers), 601FE(1)(a) (the RE's employees): cf s 182 for companies. See ALRC/CASAC report paras 10.13, 10.21. Para 10.13 recommended that this duty not to make improper use of position be applied to the RE. However, the Corporations Act only applies this duty to the RE's officers and employees, not to the RE itself. The s 601FD(1)(e) duty for the RE's officers is discussed in *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [623]-[627].
Members of a compliance committee also have duties to act honestly, to exercise reasonable care and diligence and not to make improper use of information or their position (s 601JD).

233 ss 601FC(1)(c) (the RE), 601FD(1)(c) (the RE's officers). See ALRC/CASAC report paras 10.8, 10.20.

234 *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [484].

- to use their best efforts to pursue solely the members' interests
- to act honestly and to exercise care, competence and prudence in doing so
- to adhere to the terms of the scheme constitution.[235]

The RE and its officers also have duties relating to the scheme's constitution (see Section 5.2.2, below) and compliance plan (see Section 5.2.3, below).

The purpose of imposing duties on officers of the RE as well as on the RE itself was to enable investors to take action to enforce their rights against those officers directly, without first proceeding against the RE itself.[236] Unlike the duties of officers in the corporate context, which are owed to the company itself rather than to its shareholders, the duties of the RE's officers in Chapter 5C are owed to the scheme members, rather than to the RE.[237] Also, the scheme duties may be seen as more demanding than the company duties, as they are owed to members as beneficiaries of a trust.[238] This situation will change if the SLE Proposal is adopted, as the duties of the RE and its officers would be owed to the MIS, not to the scheme members.

In addition to the above duties, the RE has duties:

- to treat the members who hold interests of the same class equally and members who hold interests of different classes fairly[239]
- to ensure that scheme property is clearly identified as scheme property and held separately from property of the RE and property of any other scheme[240]
- to ensure that the scheme property is valued at regular intervals appropriate to the nature of the property[241]
- to ensure that all payments out of the scheme property are made in accordance with the scheme's constitution and the Corporations Act[242]
- to report to ASIC any breach of this Act that relates to the scheme and has had, or is likely to have, a materially adverse effect on the interests of members as soon as practicable after it becomes aware of the breach.[243]

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235 *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [454]-[484], [607]-[614].

236 ALRC/CASAC report para 10.16.

237 *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [523]. The members are expressly referred to in the duties contained in s 601FD(1)(c), (d) and (e).

238 *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [524]-[526], [543]. The RE holds scheme property on trust for scheme members (s 601FC(2)), even if the scheme itself is not structured as a trust.

239 s 601FC(1)(d). See ALRC/CASAC report para 10.12. This duty is discussed in Section 7.1 of this paper.

240 s 601FC(1)(i). See ALRC/CASAC report para 10.11. The compliance plan of a scheme must set out the arrangements for ensuring that the requirement for separation of assets is complied with (s 601HA(1)(a)). The definition of 'scheme property' is discussed in Section 3.3 of this paper.

241 s 601FC(1)(j). Valuation of scheme assets and liabilities is discussed at Section 15.1 of this paper.

242 s 601FC(1)(k).

243 s 601FC(1)(l).

Duties under other parts of the Corporations Act and at general law

The RE may have duties at general law (such as fiduciary duties and a common law duty of care).[244]

As an RE is a public company, its directors have the same duties as the directors of any other company.[245] However, the duties imposed by the managed investment provisions in Chapter 5C (being for the benefit of scheme members) override any conflicting duty that an officer or employee has under the general corporate provisions relating to duties of officers and employees (being for the benefit of the RE, as a corporation, and, indirectly, of the RE's shareholders).[246]

The directors of the RE also have a duty to prevent the RE from trading while insolvent.[247]

In addition, directors of the RE may be personally liable in some stipulated instances in operating the scheme.[248]

Licensing provisions

As the holder of an AFSL, the RE must have adequate risk management systems for its business of operating managed investment schemes, unless the licensee is regulated by APRA,[249] which also imposes risk management requirements.[250] The RE's risk management system necessarily takes into account the risks of each of the schemes that it operates, though particular risks may not necessarily affect the RE in the same way that they affect an individual scheme. For instance, under the current law, an RE whose creditors in relation to a scheme have agreed to limited recourse rights does not have the same financial risk as the scheme. The RE's only financial risk is that the scheme may not have sufficient assets to pay the RE's remuneration and expenses. The scheme's financial risks may, however, be relevant to the reputational risk of the RE as an operator of schemes. If the SLE Proposal is adopted, the RE's financial risk will only include the financial risks of schemes under its control if scheme creditors have obtained a guarantee from the RE.

Risk management is discussed in more detail in Section 5.4.

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244 The ALRC/CASAC report envisaged that the duties it recommended would be in addition to general law duties: para 10.6. Some of the statutory duties in Chapter 5C affirm the general law duties: HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.502.3].

245 The general duties are set out in Part 2D.1, in particular ss 180–184.

246 ss 601FD(2), 601FE(2). See ALRC/CASAC report para 10.17, *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [521].

247 s 588G. Directors who fail to prevent the RE from incurring debts while insolvent are personally liable for any loss or damage suffered by creditors (s 588J), with criminal liability where this failure was dishonest (s 588G(3)).

248 s 197.

249 s 912A(1)(h). From July 2015, APRA-regulated registrable superannuation entity licensees (RSEs) that manage non-superannuation registered managed investment schemes (dual-regulated entities) will be subject to the risk management requirements of the Corporations Act licensing provisions for their non-superannuation activities: amended s 912A(1)(h) and new s 912A(5), introduced by the *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013* Schedule 1 Items 5 and 6.

250 See APRA Prudential Practice Guide SPG 200 *Risk Management* (August 2010). Listed schemes are also subject to risk management requirements under the ASX *Corporate Governance Principles and Recommendations with 2010 Amendments* (2nd edition) (see Section 5.2.7 of this paper).

An RE is also subject to the following licensing obligations:[251]

- to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly[252]
- to have adequate arrangements for the management of conflicts of interest[253]
- to comply with the licence conditions[254]
- to comply with the financial services laws and take reasonable steps to ensure that its representatives comply[255]
- unless the licensee is regulated by APRA – to have available adequate resources (including financial, technological and human resources) to provide the relevant financial services and to carry out supervisory arrangements[256]
- to maintain the competence to provide those financial services[257]
- to ensure that its representatives are adequately trained, and are competent, to provide the financial services[258]
- to have an internal and external dispute resolution system for retail clients[259]
- to have compensation arrangements for retail clients[260]
- to report to ASIC significant breaches of the above obligations[261]
- to assist ASIC in the performance of its functions.[262]

ASIC has various powers under the licensing provisions. Significantly for investors in managed investment schemes, the ASIC powers include a power to suspend or cancel the

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251 In addition to the obligations in the Corporations Act, a licensee must comply with any other obligations that are prescribed by regulations: s 912A(1)(j). One regulation has been enacted pursuant to this provision. It only applies to foreign entities that are not foreign companies: Corp Reg 7.6.03B.

252 s 912A(1)(a).

253 s 912A(1)(aa).

254 s 912A(1)(b). ASIC's power to impose licence conditions is in s 914A.

255 s 912A(1)(c), (ca). 'Financial services law' is defined in s 761A and covers various provisions in the Corporations Act, including Chapter 5C, as well as Part 2 Div 2 of the ASIC Act and Commonwealth, State and Territory legislation relating to the provision of financial services.

256 s 912A(1)(d). From July 2015, APRA-regulated registrable superannuation entity licensees (RSEs) that manage non-superannuation registered managed investment schemes (dual-regulated entities) will be subject to the Corporations Act licensing requirement to have adequate resources: amended s 912A(1)(d) and new s 912A(4), introduced by the *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013* Schedule 1 Items 4 and 6.

257 s 912A(1)(e).

258 s 912A(1)(f).

259 s 912A(1)(g), (2).

260 s 912B. These arrangements were the subject of the report *Compensation arrangements for consumers of financial services: Report by Richard St. John* (April 2012).

261 s 912D. In relation to the obligation to comply with the financial services laws in s 912A(1)(c), the reporting obligation only applies to the stipulated financial services laws in the Corporations Act and the ASIC Act: s 912D(1)(a)(ii). This limitation does not apply to the corresponding obligation to take reasonable steps to ensure that its representatives comply with the financial services laws (s 912A(1)(ca)). This appears to be an oversight.

262 s 912E.

licence of a registered scheme's RE if the scheme's members have suffered, or are likely to suffer, loss or damage because the RE has breached the Corporations Act.[263]

5.2.2 The constitution

Each scheme must have a constitution, which must make adequate provision for:

- the consideration that is to be paid to acquire an interest in the scheme
- the powers of the RE in relation to making investments of, or otherwise dealing with, scheme property
- the method for dealing with complaints made by members
- winding up the scheme.[264]

There are also certain rights or powers that must be included in a scheme's constitution if they are to exist:

- the rights (if any) that the RE is to have to be paid fees out of scheme property, or to be indemnified out of scheme property for liabilities or expenses incurred in relation to the performance of its duties
- the powers (if any) that the RE is to have to borrow or raise money for the purposes of the scheme
- the right (if any) that members are to have to withdraw from the scheme and the procedures for dealing with withdrawal requests.[265]

Section 6.1 of this paper discusses whether there should be any additional rights or powers that must be included in a scheme's constitution if they are to exist.

The constitution must be legally enforceable between the RE and the scheme members.[266] The enforceability of the constitution is discussed in Section 6.2 of this paper.

The RE has a duty to ensure that the scheme's constitution meets these requirements,[267] as well as a duty to carry out or comply with any other duty lawfully conferred by the scheme's constitution.[268] Similarly, the RE's officers have a duty to take reasonable steps to ensure that the RE complies with the scheme's constitution.[269]

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263 s 915B(3)(c). Other paragraphs of s 915B(3) enable ASIC to suspend or cancel an RE's licence if the RE ceases to carry on business, becomes externally administered or applies for ASIC to suspend or cancel the licence. Other ASIC powers include a power to direct a licensee to provide a written statement about its financial services (s 912C).

264 s 601GA.

265 s 601GA(2)-(4). ASIC has stated that 'it is not sufficient to merely state in the constitution that the key elements of the withdrawal procedures are set out in a separate document, such as a PDS' (ASIC Regulatory Guide 134 *Managed investments: Constitutions* at RG 134.156). Similarly, an RE's discretion to suspend the right to withdraw from a scheme should be set out in the scheme's constitution, not in another document (RG 134.165).

266 s 601GB.

267 s 601FC(1)(f).

268 s 601FC(1)(m).

269 s 601FD(1)(f).

The RE can unilaterally amend the scheme constitution if the RE 'reasonably considers the change will not adversely affect members' rights'.[270] Scheme members can also amend the constitution by special resolution.[271] The procedure for amending the constitution is discussed in Section 6.3 of this paper.

A company, unlike a scheme, need not have a constitution.[272] CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently. There appears to be a rationale for schemes to have a constitution. A scheme constitution is necessary to establish the respective rights and powers of the various parties involved in the scheme. By contrast, a company has the legal capacity and powers of an individual[273] (though if the company has a constitution, that constitution 'may contain an express restriction on, or a prohibition of, the company's exercise of any of its powers'[274]).

5.2.3 The compliance plan

Each registered scheme must have a compliance plan.[275] The requirements for compliance plans are discussed in more detail in Section 5.3 of this paper. The RE has duties to ensure that scheme's compliance plan meets those requirements[276] and to comply with the compliance plan.[277] Similarly, the RE's officers have a duty to take reasonable steps to ensure that the RE complies with the Corporations Act, the licence conditions, the scheme's constitution and the compliance plan.[278]

5.2.4 Meetings of scheme members

Another key aspect of the governance framework for schemes is the role of meetings of scheme members, particularly in replacing the RE of a scheme. The provisions governing the calling and conduct of meetings of scheme members are closely modelled on those applicable to companies.[279] Issues relating to meetings of members are discussed in Chapter 8 of this paper.

5.2.5 Corporations Act requirements common to schemes and companies

Some governance requirements of the Corporations Act apply to registered schemes as well as to companies, for instance:

- the requirement to keep written financial records that correctly record and explain their transactions and financial position and performance and would enable true and fair financial statements to be prepared and audited[280]
- the requirement to prepare an annual financial report and directors' report[281]

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270 s 601GC(1)(b). The principles concerning the exercise of this power by the RE are set out in *360 Capital Re Ltd (ACN 090 939 192) v Watts (as trustees for the Watts Family Superannuation Fund)*.
271 s 601GC(1)(a). See *Re Elders Forestry Management Ltd* [2012] VSC 287 at [72]-[74].
272 s 125.
273 s 124.
274 s 125.
275 Part 5C.4.
276 s 601FC(1)(g).
277 s 601FC(1)(h).
278 s 601FD(1)(f).
279 Part 2G.4. See Explanatory Memorandum to the Bill for the *Company Law Review Act 1998* paras 10.4, 10.84.
280 s 286.

- the requirement to have the financial report for a financial year audited[282]
- the requirement to provide to members a financial report, a directors' report and an auditor's report or a concise version of those reports[283]
- the obligation to keep registers[284]
- the provisions relating to the inspection of books of the scheme.[285]

Also, companies and schemes that are disclosing entities have the same continuous disclosure obligations.[286]

As mentioned in Section 5.2.4, the provisions governing the calling and conduct of meetings of scheme members are closely modelled on those applicable to companies.[287] Also, as discussed in Section 5.2.1, the duties applicable to an RE, its officers and its employees are analogous to those applicable to company officers and employees, but have been adapted to ensure that the beneficiaries of the duties are the scheme members.

5.2.6 Compliance requirements common to schemes and companies

Where a company has a statutory obligation, the duty of directors and other officers to exercise their powers and discharge their duties with care and diligence[288] requires those officers to facilitate compliance with the statutory obligation.[289] This principle would apply to the duty of care and diligence that officers of an RE have under the managed investment provisions (see the discussion in Section 5.2.1)[290] as well as the equivalent duty under the directors' duties provisions.[291]

The factors that the courts take into account in determining penalties for a contravention of the law also provide an incentive for the adoption of compliance systems. These factors, applicable whether the contravention involves a company or a scheme, include:

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281 s 292(1). This requirement applies to registered schemes, as well as disclosing entities, public companies and large proprietary companies. The only unregistered schemes that are subject to this requirement are certain recognised New Zealand schemes that are disclosing entities (see Section 14.1 of this paper). The ALRC/CASAC report recommended that scheme operators be required to give investors in schemes for which they are responsible an annual audited report on scheme activities (para 5.25).
A scheme that is a disclosing entity must also prepare a half-year financial report and director's report (s 302). The requirements for those reports are found in Part 2M.3 Div 2. The ALRC/CASAC report recommended (at para 5.31) that half-yearly reporting requirements apply to schemes.
ASIC Class Order [CO 13/1050] allows issuers of stapled securities to present consolidated or combined financial statements.

282 s 301 (see also Part 2M.1 Div 3 for audit and the auditor's report). The auditor has a right of access to the scheme's books and may make a reasonable request for any officer of the RE to give the auditor information, explanations or other assistance for the purposes of the audit or review (s 310). An officer of the RE has an obligation to allow access and give the information, explanation or other assistance requested (s 312). Those provisions refer to an officer of a registered scheme: however, that expression is taken to refer to an officer of the RE (s 285(3)). Provisions similar to ss 310 and 312 apply to controlled entities (ss 323A, 323B). For the concept of a 'controlled entity', see the definition of 'control' in s 9, s 50AA.

283 s 314. This requirement applies to registered schemes, as well as disclosing entities and companies. The only unregistered schemes that are subject to this requirement are certain recognised New Zealand schemes that are disclosing entities (see Section 14.1 of this paper).

284 Part 2C.1.

285 Part 2F.3.

286 Chapter 6CA of the Corporations Act.

287 Part 2G.4.

288 s 180.

289 This principle was applied, for instance, in *ASIC v Vines* [2005] NSWSC 738 at [1182]-[1183] in relation to a company's continuous disclosure obligation.

290 s 601FD.

291 s 180.

- the existence of compliance systems, including provisions for and evidence of education and internal enforcement of such systems

- remedial and disciplinary steps taken after a contravention and directed to implementing a compliance system or improving existing systems and disciplining officers responsible for the contravention.[292]

Furthermore, where a business conducted by a company (whether in its own right or as the RE of a scheme) is regulated by a law of the Commonwealth, the Criminal Code provides for the elements that are to be considered in proving a criminal offence against that law. Those elements encourage a focus on compliance. The Criminal Code provides:

> If intention, knowledge or recklessness is a fault element in relation to a physical element of an offence, that fault element must be attributed to a body corporate that expressly, tacitly or impliedly authorised or permitted the commission of the offence.[293]

The means by which such an authorisation or permission may be established include:

- proving that a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to non-compliance with the relevant provision; or

- proving that the body corporate failed to create and maintain a corporate culture that required compliance with the relevant provision.[294]

5.2.7 Exchange rules and guidelines

Listed schemes must comply with the listing rules of the relevant exchange. Those schemes listed on the ASX are also expected to implement best practice guidelines promulgated by the ASX Corporate Governance Council or explain why not (the 'if not why not' approach).[295] These guidelines cover such matters as ethical and responsible decision making, integrity in financial reporting and timely and balanced disclosure, as well as risk management.

In August 2013, the ASX Corporate Governance Council released a consultation paper seeking comments on a proposed third edition of the guidelines. It is anticipated that the third edition will be published in the first half of 2014.[296]

5.2.8 General law rules

A scheme is also subject to the general law rules applicable to the legal structure of the particular scheme (trust, contractual, limited partnership). In addition, trust law principles apply (regardless of the overall legal structure of the scheme) in relation to the holding of

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292 *Australian Securities and Investments Commission, in the matter of Chemeq Limited (ACN 009 135 264) v Chemeq Limited* [2006] FCA 936 at [99]. See also at [96], [112]. The *Chemeq* decision was applied in *Australian Securities and Investments Commission v Macdonald (No 12)* [2009] NSWSC 714 (see particularly at [395], [405]-[406]). See also R Baxt, 'Company law and securities: The importance of a culture of compliance' (2013) 41 *Australian Business Law Review* 106.

293 Section 12.3(1). The Criminal Code is in the Schedule to the *Criminal Code Act 1995*.

294 Criminal Code s 12.3(2)(c), (d).

295 ASX *Corporate Governance Principles and Recommendations with 2010 Amendments* (2nd edition) at 2. The Principles and Recommendations use the term 'company' to encompass any listed entity, including listed managed investment schemes (trusts) and references to 'shareholders' and 'investors' include references to unitholders of unit trusts where appropriate (see at p 7).

296 For the application of the third edition to listed managed investment schemes, see the consultation draft of the third edition at 33.

scheme property, given that the RE 'holds scheme property on trust for scheme members'.[297]

5.2.9 Remedies

Members of a scheme may have civil remedies against the RE and its directors where the scheme has been mismanaged.[298] They also have remedies at general law against the RE for breach of its common law duty of care, as well as remedies for breach of fiduciary duties against the RE and persons involved in the breach,[299] which could include officers of the RE.[300]

An RE may seek remedies on behalf of scheme members in various circumstances, including where there has been a breach of trust by a former RE or its officers.[301]

ASIC has powers to take action against REs and persons involved for breaches of the statutory duties (discussed in Section 5.2.1 of this paper).[302]

5.3 Compliance

5.3.1 The compliance plan

Corporations Act requirements

Each registered scheme must have a compliance plan, which, together with the scheme's constitution, must be lodged with an application to register the scheme.[303] The lodged copy of the compliance plan must be signed by all the directors of the RE.[304]

The compliance plan of a registered scheme must set out adequate measures that the RE must apply in operating the scheme to ensure compliance with the Corporations Act and the scheme's constitution.[305] Compliance with the Corporations Act includes compliance

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297 s 601FC(2).

298 See, for instance, ss 601MA, 1324, 1325.

299 Under the principles in *Barnes v Addy* (1874) LR 9 Ch App 244.

300 For a discussion of members' remedies, see P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶75-200.

301 See, for instance, ss 1317J(2) and 1317H. An RE may also act under general law principles to protect the interests of scheme members, and in some circumstances may be under a duty to do so. For instance, in *Young v Murphy* (1994) 12 ACLC 558 at 562, the Court observed that:

> The standing of a trustee to take proceedings to have a breach of trust redressed against a trustee or former trustee or a stranger who has become liable to redress a breach of trust is well recognised. Not only may a trustee take such proceedings, but he runs the risk of himself committing a breach of trust if he fails to do so.

See also *Permanent Trustee Australia Ltd v Perpetual Trustee Co Ltd* (1994) 15 ACSR 722. The RE's power to recover is discussed in more detail in P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶76-100-¶76-500.

302 ss 1324, 1325, a compensation order under ss 1317J(1), 1317H, ASIC Act s 50.

303 s 601EA(4)(b), Part 5C.4.

304 s 601HC.

305 s 601HA(1). It is also one of the duties of an RE as the holder of an Australian financial services licence to comply, and take reasonable steps to ensure that its representatives comply, with the financial services laws (s 912A(1)(c), (ca)). Furthermore, a licensee (other than one regulated by APRA) must have available adequate resources to carry out supervisory arrangements (s 912A(1)(d)). From July 2015, APRA-regulated registrable superannuation entity licensees (RSEs) that manage non-superannuation registered managed investment schemes (dual-regulated entities) will be subject to the Corporations Act licensing requirement to have adequate resources: amended s 912A(1)(d) and new s 912A(4), introduced by the *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013* Schedule 1 Items 4 and 6.

with conditions that ASIC imposes on the RE's licence[306] and compliance with the compliance plan itself.[307]

The matters that the Corporations Act specifies for inclusion in the compliance plan are the arrangements for ensuring that:

- all scheme property is clearly identified as scheme property and held separately from property of the RE and property of any other scheme[308]
- the compliance committee (if one is required[309]) functions properly, including adequate arrangements relating to membership, frequency of meetings, reports to the RE and access to various sources of information[310]
- the scheme property is valued at appropriate regular intervals[311]
- compliance with the plan is audited[312]
- adequate records of the scheme's operations are kept.[313]

The RE must ensure that the scheme's compliance plan contains these arrangements as well as any other measures that are needed to ensure compliance with the Corporations Act.[314]

There is also provision for compliance plans to include any other matter prescribed by the regulations.[315] There are no relevant regulations.

ASIC guidance

ASIC Regulatory Guide 132 *Managed investments: Compliance plans* (RG 132) sets out the following guidance on how to prepare a compliance plan for a managed investment scheme:

- REs should undertake a structured and systematic process that:
  - considers their obligations under the Corporations Act and the scheme constitution, including the outcomes that those obligations are designed to deliver
  - identifies the risks of non-compliance with each obligation posed by the operations of the scheme, given various relevant factors including the scheme's nature, environment, size, members and asset types
  - establishes measures designed to meet each of those risks, taking into account the likelihood and impact of failure to achieve the desired outcome of the relevant obligation[316]

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306 s 912A(1)(b) (a duty of the RE as holder of an Australian financial services licence).
307 s 601FC(1)(h) (a duty of the RE). An officer of the RE of a registered scheme must take all reasonable steps to ensure that the RE complies with the scheme's compliance plan (s 601FD(1)(f)(iv)).
308 s 601HA(1)(a). See also s 601FC(1)(i).
309 See s 601JA.
310 s 601HA(1)(b).
311 s 601HA(1)(c).
312 s 601HA(1)(d). See also s 601HG.
313 s 601HA(1)(e).
314 s 601FC(1)(g). The requirements are in s 601HA.
315 s 601HA(1)(f).

- the compliance plan should describe the key structures, systems and processes with sufficient detail to enable ASIC and the scheme auditor to assess whether the RE has complied, but without detailing every aspect[317]
- a compliance plan should be tailored to the individual scheme[318]
- compliance plans should be focused on protecting the interests of scheme members.[319] At a minimum, compliance plans should ensure that:
  - scheme property is held in a way that minimises the risk of loss by misappropriation or through insolvency of the RE[320]
  - the interests of the RE or its related parties are not placed above the interests of the member[321]
  - the RE and its officers and employees will not profit from improper use of information[322]
  - there is adherence to the scheme's investment policy[323]
  - members are told all information necessary for them to make decisions about their holdings
  - scheme members of the same class are treated equally and all scheme members are treated fairly[324]
  - members do not suffer loss because the RE does not act, or its officers or employees do not act, with reasonable care and diligence or otherwise fail in their duties.[325]

These measures should be documented in the compliance plan.[326] The compliance plan should also contain arrangements for the RE continuously to monitor, review and audit the outcomes of its compliance activities.[327]

There are also provisions in the Corporations Act and RG 132 for the compliance plan of one registered scheme to incorporate parts of the compliance plan of another registered scheme of the same RE.[328]

RG 132 does not provide a checklist of what should be in a compliance plan.[329]

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316 RG 132.2, RG 132.10-RG 132.11.
317 RG 132.4, RG 132.7, RG 132.17-RG 132.19.
318 RG 132.6(a), RG 132.8.
319 RG 132.6(b), RG 132.12.
320 cf s 601FC(1)(i). RG 132 at p 9 gives as examples of what might be included in a compliance plan the controls that ensure that scheme assets are identified appropriately and separated from those of the RE and other schemes.
321 cf ss 601FC(1)(c), 601FD(1)(c).
322 cf ss 601FC(1)(e), 601FD(1)(d), 601FE(1)(a).
323 The role of investment guidelines in scheme governance is discussed in Section 5.7.
324 cf the duty of the RE in s 601FC(1)(d). This duty is discussed in Section 7.1 of this paper.
325 cf ss 601FC(1)(b), 601FD(1)(b).
326 RG 132.13, RG 132.15–RG 132.16.
327 RG 132.14.
328 s 601HB, RG 132.20-132.22.
329 RG 132.3.

In addition to RG 132, ASIC has issued regulatory guides containing commentary on compliance plans for particular types of schemes.[330] Those regulatory guides include advice that better compliance plans:

- use plain language
- include an overview about the plan, its scope and aim and where it sits in the RE's compliance and risk management framework
- contain clear information about relevant obligations, the risks of non-compliance with those obligations, procedures to meet the obligations, how those procedures are monitored and who is responsible for monitoring
- focus on the tasks that staff must perform, to enable them to find out easily who is responsible for a certain task, when or how often the task must be performed, how they can meet their obligations and how their work will be monitored
- state when reporting on compliance must take place, using specific dates or references to timeframes (for instance, 'no less than monthly')
- outline how breaches are reported, who is responsible for rectifying them and what action needs to be taken.

In addition, ASIC guidance on disclosure for particular types of scheme requires that the compliance plans for those schemes contain adequate procedures to ensure that REs comply with their initial and ongoing disclosure and advertising obligations.[331]

5.3.2 The compliance committee

Where less than half of the directors of the RE are external directors, the RE must establish a compliance committee to report on the RE's compliance with the compliance plan.[332]

The functions of a scheme's compliance committee are:

- to monitor the extent to which the RE complies with the compliance plan and to report on its findings to the RE
- to report to the RE any breach of the Corporations Act or the scheme's constitution of which the committee becomes aware or that it suspects
- to report to ASIC if the committee is of the view that the RE has not taken, or does not propose to take, appropriate action to deal with a matter reported to it

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330 Regulatory Guide 116 *Commentary on compliance plans: Agricultural industry schemes*, Regulatory Guide 117 *Commentary on compliance plans: Financial asset schemes*, Regulatory Guide 118 *Commentary on compliance plans: Contributory mortgage schemes*, Regulatory Guide 119 *Commentary on compliance plans: Pooled mortgage schemes*, Regulatory Guide 120 *Commentary on compliance plans: Property schemes*.

331 Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors*, particularly at RG 45.179-RG 45.180, Regulatory Guide 46 *Unlisted property schemes: Improving disclosure for retail investors*, particularly at RG 46.168.

332 Part 5C.5, in particular ss 601JA(1), 601JC.

- to assess at regular intervals whether the compliance plan is adequate, to report to the RE on the assessment and to make recommendations to the RE about any changes that it considers should be made to the plan.[333]

There are no legislative requirements concerning the experience, competence or qualifications required for a person to be a compliance committee member (though the compliance plan must include adequate arrangements relating to the membership of the compliance committee[334]).

There are requirements about the minimum number of members of a compliance committee,[335] its overall composition,[336] its functions,[337] the duties of its members,[338] the circumstances in which the RE can indemnify, and pay insurance premiums for, the members of the committee[339] the keeping of minutes of meetings and records of recommendations and reports[340] and disclosure of conflicts of interest.[341]

The compliance plan must include adequate arrangements relating to how often compliance committee meetings are to be held and the committee's reports and recommendations to the RE.[342] In other respects, compliance committees may regulate themselves and their proceedings as they consider appropriate (as long as they do so consistently with the compliance plan).[343]

A member of a scheme's compliance committee has qualified privilege in respect of a statement concerning the operation of the scheme made by or on behalf of the committee, or a member of the committee, to the RE or to ASIC.[344] This qualified privilege does not continue once a person ceases to be a member of a compliance committee.

ASIC has observed:

> The compliance committee is intended to act as an intermediary between the operational compliance unit and board of directors in relation to compliance monitoring, assessment and reporting. Given ASIC's finite resources, the compliance committee also plays an important role as 'gatekeeper'.[345]

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333 s 601JC. In carrying out its functions, the compliance committee may commission independent legal, accounting or other professional advice or assistance, at the reasonable expense of the RE (s 601JC(2)).
334 s 601HA(1)(b)(i).
335 s 601JB(1), (5)-(7).
336 s 601JB(1)-(4).
337 s 601JC.
338 s 601JD.
339 s 601JF-601JG.
340 s 601JH.
341 s 601JJ.
342 s 601HA(1)(b)(ii), (iii).
343 s 601JH(1).
344 s 601JE.
345 PJC Trio report, para 1.43. KPMG, in its submission to the PJC Trio inquiry, noted that the purpose of compliance committees is independently monitoring the area performing the primary compliance function of the RE and reporting on its functioning to the RE's board. However, KPMG also observed that the independent operation of the committee may be compromised given that the RE has the responsibility for ensuring the proper functioning of the compliance committee and the committee meets only a few times a year (PJC Trio report, paras 5.17-5.18).

5.3.3 Audit of the compliance plan

Corporations Act

Compliance with a scheme's compliance plan must be audited each year.[346] ASIC has said:

> The purpose of requiring an audit of the compliance plan is to ensure the compliance plan is current at all times.[347]

Within three months after the end of a financial year of a scheme, the auditor of the scheme's compliance plan must:

- examine the compliance plan
- carry out an audit of the RE's compliance with the compliance plan during the financial year
- give the RE a report that states whether, in the auditor's opinion:
  - the RE complied with the scheme's compliance plan, and
  - the plan continues to meet the Corporations Act requirements.[348]

The compliance plan auditor must be a company auditor registered under the Corporations Act.[349] However, the auditor cannot be:

- an associate of the RE
- an agent holding scheme property on behalf of the RE or an associate of such an agent
- the auditor of the RE's financial statements[350]

though the auditor of the compliance plan and the auditor of the RE's financial statements may work for the same firm of auditors or audit company, as may the lead auditor or review auditor of the compliance plan (on the one hand) and the lead auditor or review auditor of the RE's financial statements (on the other hand).[351]

In some instances, there may be an overlap between the financial services licensing requirements for REs (which may, in particular cases, specifically require an audit) and the auditing standards and compliance plans for the schemes that they manage. The proposal in the 2012 CAMAC report that each new scheme be operated only by a sole–function RE[352] might reduce the potential for overlap between any audit of the RE and the audit of the scheme.

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346 s 601HG(1).
347 PJC Trio report para 1.42.
348 s 601HG. Auditing and Assurance Standards Board GS 013 *Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes* interprets this requirement as meaning that the plan continues to meet the Corporations Act requirements as at the end of the scheme's financial year (para 22, footnote 4).
349 s 601HG(1).
350 s 601HG(2).
351 s 601HG(2A).
352 Section 1.6.1.

When a meeting of members is being held, the auditor of the compliance plan must be given written notice of the meeting and any other communications relating to the meeting that a scheme member is entitled to receive.[353]

ASIC guidance

The measures in the compliance plan should be set out with enough certainty to allow the auditor of the compliance plan (as well as ASIC) to assess whether the RE has complied with the compliance plan.[354]

Auditing and Assurance Standards Board guidance

Auditing and Assurance Standards Board GS 013 *Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes* gives guidance for those planning, conducting and reporting on the audit of a scheme's compliance plan,[355] including the following:

Audit engagement letter

- the terms of the compliance plan audit engagement with the RE may be outlined in an audit engagement letter[356]
- the audit engagement letter may also:
  - outline arrangements for liaison with the RE's compliance committee (if there is one), other compliance advisers and other auditors, including the auditor of the RE's financial report and the auditor of the scheme's financial report[357]
  - clarify the respective roles of the RE's directors and auditor[358]

Inherent limitations of auditing compliance with the compliance plan

- an audit opinion is expressed in terms of reasonable assurance, as it cannot constitute a guarantee that the compliance plan is completely free from any deficiency or that all compliance breaches have been detected[359]
- the auditor performs tests periodically throughout the financial year, as there are practical limitations in requiring an auditor to perform a continuous examination of the compliance plan[360]

Planning and conduct of the audit

- as compliance plans vary between different REs and their respective schemes, it will be necessary for the auditor to apply professional judgement when applying audit procedures and evaluating compliance plans and the design of compliance measures,

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353 ss 252G, 252H.

354 RG 132.4. See also Auditing and Assurance Standards Board GS 013 *Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes* at para 12.
ASIC is consulting on various matters relating to the resignation, removal and replacement of auditors: Consultation Paper 209 *Resignation, removal and replacement of auditors: Update to RG 26* (May 2013).

355 ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* and ASAE 3100 *Compliance Engagements* are also relevant to these audits.

356 para 18.

357 para 19.

358 para 20.

359 para 23.

360 para 24.

having regard to the size and complexity of the particular scheme under examination[361]

- the auditor considers materiality in the context of the RE's compliance objectives when determining the nature, timing and extent of audit procedures and evaluating the effect of identified compliance plan breaches or weaknesses in compliance measures[362]

- the auditor considers the adequacy of the measures in the compliance plan, key responsibilities and risks, processes to implement the measures and processes established by the RE to monitor adherence to the compliance plan,[363] as well as the scheme's constitution, any conditions on the RE's licence, any recent changes to the compliance plan, any changes to the operation of the scheme, any legislative changes and various auditors' and other reports[364]

The audit report

- the auditor is expected to report significant detected breaches that, either individually or collectively, the auditor judges to be material (based on qualitative as well as quantitative factors)[365]

- before issuing the auditor's report on the compliance plan audit, the auditor seeks a written representation from the directors of the RE containing their assertions that the RE has complied with the scheme's compliance plan during the financial year and that the plan continues to meet the requirements of Part 5C.4[366]

- the report is addressed to the scheme's RE.[367]

5.4 Risk management

Corporations Act requirements

The other major element of the internal monitoring framework derives from the fact that the RE of a managed investment scheme must have an Australian financial services licence. One of the licensee obligations is to have adequate risk management systems[368] (unless the licensee is regulated by APRA,[369] which also imposes risk management requirements[370]).

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361 para 26.

362 paras 27-28. However, there is no express provision that permits an auditor to disregard immaterial non-compliance.

363 paras 31-32.

364 para 33.

365 paras 29-30. However, there is no express provision that permits an auditor to disregard immaterial non-compliance.

366 para 38.

367 para 39. Other matters are set out in paras 34-37. The report is also lodged with ASIC and is available for public inspection.

368 s 912A(1)(h). A person's application to become a licensee must include information about the person's arrangements for complying with the general licensee obligations (s 913A(a), Corp Reg 7.6.03(g)).

369 s 912A(1)(h). From July 2015, APRA-regulated registrable superannuation entity licensees (RSEs) that manage non-superannuation registered managed investment schemes (dual-regulated entities) will be subject to the risk management requirements of the Corporations Act licensing provisions for their non-superannuation activities: amended s 912A(1)(h) and new s 912A(5), introduced by the *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013* Schedule 1 Items 5 and 6.

370 See APRA Prudential Practice Guide SPG 200 *Risk Management* (August 2010).

ASIC guidance

ASIC has provided guidance on what this risk management obligation requires, both generally for all AFS licensees and specifically for REs.

Regulatory Guide 104 *Licensing: Meeting the general obligations* (2007) (RG 104) provides general guidance on what ASIC looks for when assessing the general AFS licensee obligations, including the requirement to have adequate risk management systems.[371] RG 104 states that ASIC expects that a licensee's compliance measures will take into account the specific compliance risks of its business, especially those that may materially affect consumers or market integrity.[372] The guide requires that a licensee's risk management system:

- be based on a structured and systematic process that takes into account the licensee's obligations under the Corporations Act
- identify and evaluate risks faced by its business, focusing on risks that adversely affect consumers or market integrity (this includes risks of non-compliance with the financial services laws)
- establish and maintain controls designed to manage or mitigate those risks
- fully implement and monitor those controls to ensure they are effective.[373]

It states that risk management systems will depend on the nature, scale and complexity of the licensee's business and its risk profile.[374]

ASIC Report 298 *Adequacy of risk management systems of responsible entities* (September 2012) presents the results of a review, conducted in 2011-12, of how REs specifically managed financial, investment and liquidity risk. Key findings of that report included:

- some of the most sophisticated risk management systems (adopted by REs that were part of an APRA-related group) were based on a 'three lines of defence' risk management model focused on checks and balances for management, compliance and risk management, and independent audit
- the REs covered by the review generally appeared to demonstrate compliance with their obligation as AFS licensees to maintain adequate risk management systems, although improvements could be made, particularly for non–APRA regulated REs
- each of the selected REs had a unique risk management system that reflected the nature, scale and complexity of its financial services business
- a resource adequacy risk specific to small REs was that the skills and experience required by the RE were concentrated in one or two key people and/or that the RE may rely too much on compliance and risk management consultants to establish and monitor risk management systems

371 s 912A(1)(h).
372 RG 104.42.
373 RG 104.62. See also RG 104.47.
374 RG 104.63.

- the REs relied on disclosure of investment and liquidity risks, the responsibility for which they then regarded as being with the investors
- most of the selected REs conducted little or no stress testing and, where it was conducted, there were diverse approaches
- most of the selected REs indicated that their risk management system did not change as a result of the global financial crisis.

Subsequently, ASIC released Consultation Paper 204 *Risk management systems of responsible entities* (March 2013), which consulted on proposals for more targeted requirements for risk management systems of REs and draft guidance for complying with these requirements.

Most recently, ASIC's Regulatory Guide 133 *Managed investments and custodial or depository services: Holding assets* gave some risk management guidance in relation to the holding of assets.[375]

Richard St. John report

A possible risk management system for schemes was raised in the report *Compensation arrangements for consumers of financial services: Report by Richard St. John* (April 2012):

> One possibility would be to require responsible entities of managed investment schemes to have a risk management system that reflects the nature, scale and complexity of its business. The risk management system might also require independent scrutiny, such as an assessment by an auditor that the controls adequately safeguard investment assets held on a pooled basis and mitigate the risk of fraud. Licensees would be expected to include a process to monitor their risks on an ongoing basis and update their controls as required.[376]

ASX

The ASX *Corporate Governance Principles and Recommendations with 2010 Amendments* (2nd edition) are relevant for managed investment schemes listed on the ASX (see Section 5.2.7 of this paper).[377] *Principle 7 Recognise and manage risk* states:

> Companies should establish a sound system of risk oversight and management and internal control.
>
> - Recommendation 7.1: Companies should establish policies for the oversight and management of material business risks and disclose a summary of those policies.
> - Recommendation 7.2: The board should require management to design and implement the risk management and internal control system to manage the company's material business risks and report to it on whether those risks are being managed effectively. The board should disclose that management has reported to it as to the effectiveness of the company's management of its material business risks.

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375 See RG 133.40 (risks associated with employee functions and measures to deal with fraud risks), RG 133.51 (pre-contract inquiries in relation to the RE's clients) and RG 133.74 (the risks of the RE engaging another party to hold scheme assets).

376 para 3.55.

377 The Principles and Recommendations use the term 'company' to encompass any listed entity, including listed managed investment schemes (trusts) (see at p 7).

- Recommendation 7.3: The board should disclose whether it has received assurance from the chief executive officer (or equivalent) and the chief financial officer (or equivalent) that the declaration provided in accordance with section 295A of the Corporations Act is founded on a sound system of risk management and internal control and that the system is operating effectively in all material respects in relation to financial reporting risks.

- Recommendation 7.4: Companies should provide the information indicated in the Guide to reporting on Principle 7.

In August 2013, the ASX Corporate Governance Council released for comment a proposed third edition of the *Corporate Governance Principles and Recommendations*.[378] The proposed revision of *Principle 7 Recognise and manage risk* states:

> A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.
>
> - Recommendation 7.1: The board of a listed entity should:
>
> (a) have a risk committee which:
>
> (1) has at least three members, a majority of whom are independent directors; and
>
> (2) is chaired by an independent director,
>
> and disclose
>
> (3) the charter of the committee;[379]
>
> (4) the members of the committee; and
>
> (5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or
>
> (b) include within the responsibilities of the audit committee the responsibilities normally undertaken by a risk committee;[380] or
>
> (c) if it does not have a risk committee (whether as a stand-alone committee or as part of the responsibilities of the audit committee), disclose that fact and the processes it employs for identifying, measuring, monitoring and managing the material business risks it faces.

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[378] For the application of the third edition to listed managed investment schemes, see the consultation draft of the third edition at 33.

[379] The draft states (at 29) that the role of the risk committee, which would be set out in its charter, 'is usually to review and make recommendations to the board in relation to:

- the adequacy of the entity's processes for identifying, measuring, monitoring and managing the material business risks it faces;
- any incident involving fraud or other break down of the entity's internal controls; and
- the entity's insurance program, having regard to the entity's business and the insurable risks associated with its business'.

The charter would also confer on the committee the powers necessary to perform its role, which would usually include 'the right to obtain information, interview management and internal and external auditors (with or without management present), and seek advice from external consultants or specialists where the committee considers that necessary or appropriate'.

[380] The draft states (at footnote 28): 'If the responsibilities of the audit committee are expanded to cover the responsibilities that would normally be undertaken by a risk committee, it is generally a good idea to refer to the committee as the "audit and risk committee" so that investors understand the full extent of the role undertaken by the committee.'

- Recommendation 7.2: The board or a committee of the board should:

  (a) review the entity's risk management framework with management at least annually to satisfy itself that it continues to be sound, to determine whether there have been any changes in the material business risks the entity faces and to ensure that they remain within the risk appetite set by the board; and

  (b) disclose in relation to each reporting period, whether such a review has taken place.

- Recommendation 7.3: A listed entity should disclose:

  (a) if it has an internal audit function, how the function is structured and what role it performs; or

  (b) if it does not have an internal audit function, that fact and the processes it employs for evaluating and continually improving the effectiveness of its risk management and internal control processes.

- Recommendation 7.4: A listed entity should disclose whether, and if so how, it has regard to economic, environmental and social sustainability risks.

International

There are international guidelines on risk management for schemes.

The International Organization of Securities Commissions (IOSCO) publication *Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (2011) states that the regulatory standards for schemes should require a comprehensive risk management framework supported by an independent risk management function, appropriate to the size, complexity and profile of the scheme.[381] IOSCO has also published principles of liquidity risk management for collective investment schemes.[382]

In addition, there is an international standard for risk management, which is not specific to the managed funds sector.[383]

Risk management standards for schemes might also draw on international standards applicable to companies. The *OECD Principles for Corporate Governance* (2004) require that companies have systems for risk management.[384]

Other jurisdictions have adopted risk management standards. For instance, the United Kingdom Corporate Governance Code (2012) requires company boards to:

- determine the nature and extent of the significant risks they are willing to take in achieving their strategic objectives[385]

- maintain sound risk management and internal control systems[386]

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381 This requirement relates to Principle 28, which relates to ensuring appropriate oversight. Principle 28 is one of a set of principles relating to collective investment schemes and hedge funds.

382 Final report, *Principles of liquidity risk management for collective investment schemes* (FR 03/13, March 2013).

383 ISO 31000:2009 *Risk management: Principles and guidelines*. This standard was based on an Australia/New Zealand initiative and was developed from AS/NZS 4360:2004. See also *Risk management guidelines - Companion to AS/NZS ISO 31000:2009* (SA/SNZ HB 436:2013).

384 Principle VI.D.7.

385 Section C.2.

- at least annually conduct a review of the effectiveness of the company's risk management and internal control systems and report to shareholders that they have done so.[387]

Also, guidance on risk management for investment companies has been introduced by the Monetary Authority of Singapore (MAS)[388] and the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).[389]

5.5 Assessment of the current scheme governance framework

5.5.1 Comparison with the corporate governance framework

As discussed in Section 5.2.1, many of the duties of the RE and its officers and employees under the scheme provisions are analogous to those of officers and employees of a company under the general Corporations Act provisions (though the scheme duties of officers and employees of an RE[390] take priority over their general duties). Also, as discussed above, the scheme governance and corporate governance frameworks have in common certain Corporations Act requirements (Section 5.2.5), certain factors favouring a culture of compliance (Section 5.2.6) and, in the case of schemes and companies listed on the ASX, the ASX Listing Rules and ASX Corporate Governance Council guidelines (Section 5.2.7).

However, some key investor protection features of corporate governance do not apply to schemes.

While scheme members can remove the RE of a scheme,[391] they have no role in the appointment or replacement of the directors of the RE. By contrast, a company's shareholders can appoint its directors by resolution in general meeting[392] (unless the company's constitution provides otherwise[393]). Similarly, company shareholders can remove a director (the constitution of a proprietary company can provide otherwise,[394] but this right is always available to members of a public company[395]).

Scheme members also do not have access to the statutory derivative action procedure[396] (under which they might be able to bring proceedings against defaulting officers of the RE on behalf of the RE where the RE itself was unwilling to take action), nor is the oppression remedy[397] available to them.

In addition, a wide-ranging body of law (including case law) and practice that provides a well-established set of rules for corporate governance has developed over time. Industry

386 ibid.
387 Code Provision C.2.1.
388 'MAS Implements Enhanced Regulatory Regime for Fund Management Companies', MAS media release, 6 August 2012.
389 BaFin Circular 4/2010 (WA) *Minimum requirements for the compliance function and additional requirements governing rules of conduct, organisation and transparency pursuant to sections 31 et seq. of the Securities Trading Act (Wertpapierhandelsgesetz—WpHG) for Investment Services Enterprises* (2011).
390 s 601FD.
391 s 601FM.
392 s 201G.
393 Section 201G is a replaceable rule. A replaceable rule can be displaced or modified by the company's constitution (s 135(2)).
394 s 203C, which is a replaceable rule (see previous footnote).
395 s 203D.
396 Part 2F.1A.
397 Part 2F.1.

bodies run courses to promote awareness of corporate governance law and practice on the part of those who manage companies. Schemes (many of which are major businesses) are a discrete legislative structure, designed to be a passive investment vehicle, and do not have the same breadth of entrenched governance law and practice as is available for companies. It cannot be automatically assumed that the courts would apply corporate governance jurisprudence to scheme governance.

The absence of these corporate governance elements from the scheme governance framework raises the question whether some additional governance features for schemes, to provide investors in schemes with governance protection comparable to that for investors in companies, are required. Under the current regulatory framework, these additional features are provided by the scheme's constitution,[398] the compliance requirements (consisting of a compliance plan and either a majority of external directors of the RE or a compliance committee) and the risk management obligations of the RE (which encompass the risks faced by the schemes that it operates). In practice, a scheme may also have an investment manager and a custodian, though these roles are not required by the Corporations Act.

Sections 5.5.2 and 5.5.3 of this paper discuss the operation of the compliance and risk management elements of the current framework in practice, while Section 5.6 discusses possible options for reforming the current compliance/risk management structure.

5.5.2 Compliance

There has been a tendency for compliance plans to be cast in general terms, rather than designed to suit the circumstances of the particular schemes to which they relate. The measures stated in those plans are then supplemented by detailed compliance procedures and processes in separate manuals.

There are several possible reasons for this trend:

- the range of matters that the Corporations Act requires to be included in compliance plans[399] is limited
- liability for breach of a compliance plan attaches to any contravention of the plan rather than just material contraventions (so that the fewer the number of specific requirements in the plan, the less opportunity there is for breaches that would attract liability)[400]
- many compliance risks and the measures that an RE will apply to deal with them apply to schemes generally or to all schemes of a particular kind.

This tendency to have general compliance plans is contrary to ASIC guidance, which advises that a compliance plan should be tailored to the individual scheme[401] and contain sufficiently certain measures to allow ASIC and the auditor of the compliance plan to

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398 A company may, but does not have to, have a constitution: its internal management may be governed by the replaceable rules in the Corporations Act (see s 135), by a constitution or by a combination of both (s 134). If a company has a constitution, the Corporations Act does not prescribe any matters that it must contain. By contrast, certain matters are prescribed for inclusion in a scheme constitution (see s 601GA and the discussion at Sections 5.2.2 and 6.1 of this paper).

399 s 601HA(1).

400 PJC Trio report paras 4.50, 5.19, 5.21.

401 RG 132.6(a).

assess whether the RE has complied with the compliance plan.[402] Furthermore, reduced detail in the compliance plan may reduce the likelihood of an auditor identifying non-compliance with the compliance plan.

Given the general nature of many compliance plans, compliance plan audits, which are only required to 'audit compliance with the scheme's compliance plan',[403] are often similarly limited in nature. They are backward-looking in that they examine whether the past conduct of the scheme complied with relevant requirements (though the auditor must give an opinion on whether the plan continues to meet the statutory requirements[404]). They do not deal with the broader operation of a scheme's business, including how it identifies and manages risk. Such a broader purpose would assist in conducting the scheme's business and planning for the future and might form part of any risk management framework specifically for schemes (as opposed to risk management systems for the REs that operate them) (see Section 5.6).

An ASIC review of compliance plan audits for the 2011-12 financial year has also revealed other deficiencies in these audits. It found that, where certain functions are outsourced (for instance, custodial or investment administration or back-office accounting), compliance plan auditors often rely on the auditors of the service organizations in relation to:

- the design, implementation and/or effectiveness of operating controls
- specific assertions such as valuation and existence of investments.[405]

ASIC found that auditors of compliance plans did not always obtain sufficient and appropriate audit evidence on which to base their conclusions in areas such as:

- whether the compliance plan continued to meet the statutory requirements (Part 5C.4)
- the adequacy of procedures for reporting and assessing breaches of the compliance plan
- the assessment of whether the service organization auditor's report could be relied on in relation to outsourced functions, risk assessments performed by the auditors, and the relationship to work performed on areas of the compliance plan audit
- the testing of specific areas, such as subsequent events up to the date of issuing the compliance plan audit report, calculations of net tangible assets (for the RE) and cash flow projections.[406]

5.5.3 Risk management

ASIC Report 298 *Adequacy of risk management systems of responsible entities* (September 2012) found that the REs that ASIC selected for review generally appeared to demonstrate compliance with their licensing obligation to maintain adequate risk

402 RG 132.4.
403 s 601HG(1).
404 s 601HG(3)(c).
405 ASIC Report 317 *Audit inspection program report for 2011–12*, para 56.
406 id at para 57.

management systems.[407] However, the report identified various inadequacies in the risk management systems of the selected REs, including:[408]

- the risk management systems did not change in response to significant events that affected the risk profile of the relevant scheme, such as the global financial crisis
- small REs had the following specific resource adequacy risks:
  - concentration of the skills and experience required by the RE to successfully run a financial services business in one or two people who are crucial to its operation or have dominance in its culture (key person risk)
  - overreliance on external compliance and risk management consultants, who are not closely linked to the organization, to establish and monitor risk management systems
- little or no stress testing by most of the selected REs that are not part of an APRA-regulated group. Where stress testing practices are adopted, there appears to be a diversity of approach, which may be explained by the nature, scale and complexity of an RE's business.

The report also identified the following areas that may require further attention from some of the selected REs:

- the extent to which risk management systems are embedded in strategic and business planning, as well as day-to-day operations
- risk appetite
- risk identification, assessment and management (particularly where the approach taken to these involves electronic systems designed and tested by external compliance and risk management consultants without consideration by the board of the RE or an independent risk or compliance committee)
- treatment of residual risk (the remaining risk after the exercise of risk controls)
- the impact of the global financial crisis on risk management systems.[409]

Any risk management framework specifically for schemes (see Section 5.6) might take into account the matters raised in ASIC Report 298.

5.6 Reform options

5.6.1 Overview

Extension of the corporate governance framework to schemes

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

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407 Table 2 at p 15.
408 Table 1 at pp 5-6.
409 paras 33-56.

One way of applying that approach in the governance context would be to extend to schemes some of the features of the corporate governance framework that do not currently apply to schemes. For instance, the categories of those having standing to bring an action for oppression[410] or to initiate a statutory derivative action[411] could be extended to include, where the company is an RE, members of a registered scheme that the RE operates.

However, it would not be desirable to replicate the control that shareholders have over the personnel who manage the company in the context of schemes. It would be inappropriate to give scheme members the power to vote on the appointment or removal of the directors of the RE. An RE is a company with its own shareholders, who should not have their votes diluted by persons who are external to the company. Those external persons could be numerous if the RE operates a large scheme or a large number of schemes.

Also, it is not possible simply to apply to schemes the considerable body of corporate governance law and practice that has developed over a lengthy period of time (see Section 5.5.1). While the regulatory regimes for schemes and companies have certain common features (as discussed in Sections 5.2.1, 5.2.5-5.2.7 and 5.5.1), there are differences between these two commercial structures that would need to be taken into account in any effort to bring the respective governance regimes into closer alignment. The corporate structure was introduced as a vehicle for entrepreneurial risk-taking and the law relating to companies has developed over a long period of time. The scheme structure was developed more recently as an investment vehicle (particularly for retail investors), though it has trust elements that are governed by long-standing principles of trust law (as discussed in Chapter 2 of this paper).

Modification of the compliance and risk management framework

Given the potential complexities and difficulties of extending some aspects of the corporate governance framework to schemes, increased protection for investors in schemes may best be promoted by focusing on the need for changes to the current compliance and risk management framework in response to the matters raised in Section 5.5. Options include:

- *Option 1:* retain the current framework (compliance plan supplemented by risk management obligations of the RE as a licensee)
- *Option 2:* introduce a risk management regime specifically for schemes that would operate side by side with the compliance regime and link into the risk management framework for REs that operate them
- *Option 3:* remove the current compliance regime, with compliance to be dealt with as part of a broader risk management framework for schemes that could link in with the risk management framework for the REs that operate them.

A focus on risk management specifically for schemes, as envisaged in Option 2 or Option 3, may be justifiable, given the widespread failure of risk management during the global financial crisis. The OECD report *Corporate Governance and the financial crisis – Conclusions and emerging good practices to enhance implementation of the Principles* (2010) noted, in relation to companies:

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410 s 234.
411 s 236(1).

> In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often separated from management and not regarded as an essential part of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company.[412]

Section 5.7 discusses the role of investment guidelines in the scheme governance framework. These guidelines could form part of a risk management regime under any of the three identified governance options.

In assessing the reform options, account needs to be taken of the fact that REs of schemes may also be trustees of superannuation funds, which are subject to a separate risk management regime.

5.6.2 The reform options in detail

Option 1 (retain the current framework)

Under this option, there would continue to be a requirement for schemes to have a compliance plan, as well as a compliance committee where less than half of the directors of the RE are external directors, and for compliance with the plan to be audited.

Risk management would remain a general licensee obligation of the RE.

If the current framework is retained, there is an issue about whether steps should be taken to improve the quality of compliance plans.

One approach, supported by ASIC, is to change the law relating to compliance plans to focus on material breaches rather than minor breaches: in ASIC's view, this would encourage the development of a strong compliance culture within REs.[413] ASIC suggested amending the RE duty and liability provisions[414] and the officer duty and liability provisions[415] to remove the liability for a non-material breach of the compliance plan.[416]

Other approaches to discouraging high level compliance plans that lack detail would be:

- to define compliance plan in the Corporations Act so that it covers all the company's documents that deal with compliance with the law
- for the Corporations Act to prescribe additional (or alternative) matters that must be included in the compliance plan, for instance, valuation frequency (not just arrangements for ensuring that scheme property is valued at regular intervals, as at present[417]), compliance committee processes and a detailed description of the registered managed investment scheme and its investment strategy.[418]

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412 para 35, Box 2.
413 PJC Trio report para 4.52.
414 s 601FC.
415 s 601FD.
416 The ASIC submission to the PJC noted (at para 133) that the Productivity Commission declined to accept these suggestions, which were originally made in February 2010 to the Productivity Commission's Annual Review of Regulatory Burdens on Business and Consumer Services.
417 s 601HA(1)(c).
418 The PJC Trio report recommended that the government investigate options to improve the oversight and operation of compliance plans, focusing particularly on the need for more detail to be included in compliance plans (rec 7).

An argument in favour of Option 1 is that it may avoid the need for existing schemes to introduce a new governance framework, as under Option 2 or Option 3 (though Option 3 has the potential to streamline requirements by enabling REs to deal with compliance in the broader context of risk management rather than requiring them to implement separate procedures for compliance and risk management).

Given that Option 1 involves retaining the basic overall legislative structure, the compliance committee and auditing of compliance with the compliance plan would remain an important part of the governance framework.[419] The introduction of more detailed requirements for the matters to be included in the compliance plan may result in more useful audit reports.

The PJC Trio report supported a review of the effectiveness of compliance plans and, if necessary, requiring more detail to be provided in these plans.[420]

Option 2 (strengthened risk management alongside compliance)

This option would involve retention of the requirement for a compliance plan (possibly with steps being taken to improve the quality of those plans, as discussed under Option 1), together with the introduction of legislative risk management requirements for schemes that would link in with the current licensing obligation for a scheme's RE to have adequate risk management systems. In practice, an RE would be able to have a single risk management system that deals with risks separately at the RE level and at the scheme level.

The purpose of the risk management requirements for schemes would be to provide a governance framework that encourages attention being given to the full range of risks that might be involved in the conduct of the scheme's business, not just compliance risk. Matters that might be provided for in a risk management regime for schemes might include:

- the procedure for identifying and assessing relevant risks
- the procedure for determining how to deal with identified risks
- monitoring compliance with the risk management system
- ensuring that the risk management system can adapt in response to significant changes in the risk profile of the relevant scheme
- the procedure for outsourcing a risk management system
- record-keeping and reporting.[421]

See ASIC submission to the PJC Inquiry into the collapse of Trio Capital Limited, para 148(a). See also paras 132(a), 135(b), 137. The ASIC submission to the PJC noted that the Productivity Commission declined to accept these suggestions, which were originally made in February 2010 to the Productivity Commission's Annual Review of Regulatory Burdens on Business and Consumer Services: para 133.

419 CAMAC notes that KPMG, in a submission to the PJC Trio inquiry, raised the possibility of a stronger role for compliance committees, which may include holding management accountable for acting on recommendations of the compliance committee (PJC Trio report para 5.16). That KPMG submission also raised the contrasting possibility of removing the need for a compliance committee by mandating a majority of truly independent directors of the RE. The PJC Trio report did not take a view on these alternatives.

420 p xxiii, paras 4.55, 7.34-7.35 (rec 7), 9.21.

The risk management regime for schemes could either itself set standards in these areas or require that a scheme's RE set risk management standards for that scheme in relation to each of the specified criteria.

Issues under this option would include:

- whether a scheme's risk management regime should be in writing
- whether there should be specific requirements for particular types of risk and, if so, for what risks and what requirements should apply to those risks (for instance, in relation to a scheme that involves ongoing investment of members funds, whether a scheme's risk management system should be required to include appropriate investment guidelines: this issue is discussed in more detail in Section 5.7[422]).

An argument in favour of Option 2 is that it would enable schemes to preserve their current compliance regimes, while at the same time promoting a greater focus on risk management.

The comments made under Option 1 about the detail to be included in the compliance plan would be equally applicable under Option 2.

Adoption of Option 2 would raise the question whether the move to a stronger risk management regime would obviate the need for a compliance committee to oversee the RE's compliance with the compliance plan or be a means for independent monitoring. This may especially be the case if the new risk management regime includes a requirement for a risk committee (see the discussion of the appropriate governance structure for monitoring risk management under Option 3, below).

As with Option 1, more detailed compliance plans may increase the usefulness of audits of those plans. However, under Option 2, the question arises whether there should be an audit of the risk management system instead of, or in addition to, an audit of the compliance plan. Audit of risk management arrangements is further discussed under Option 3, below.

Option 3 (subsume compliance into risk management)

Under this option, a scheme's compliance risk would not be subject to a discrete set of requirements, as under the current law, but would be one of the risks covered by a risk management framework for schemes, which would link in with the RE's risk management obligation. As with Option 2, an RE would in practice be able to have a single risk management system that deals with risks separately at the RE level and at the scheme level.

Arguments for adopting Option 3 include:

- the current compliance plan requirement only covers compliance risk (the risk that the RE will fail to comply with applicable laws in its operation of the scheme).

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421 These factors were discussed in ASIC Consultation Paper 204 *Risk management systems of responsible entities* (March 2013).

422 ASIC currently recommends that a compliance plan should ensure that there is adherence to the scheme's investment policy: RG 132.12(d).

Compliance risk is not the only risk a scheme faces and may not be the most important risk[423]

- mere adherence to a compliance plan does not adequately deal with risks[424]
- a greater regulatory emphasis on risk management for schemes may help focus the attention of REs on the key strategic, enterprise and other business risks facing each of the schemes that they operate, as commercial entities, rather than merely compliance risk, which is just one of the risks of a commercial enterprise. This, in turn, may create a climate that is more conducive to good decision making. Risks change regularly
- it would be more sensible to deal with compliance and other types of risk in a single integrated document, rather than requiring that REs develop two separate sets of procedures for what are related concepts
- as discussed in Section 5.5 and in this Section under Option 1, the details in the current compliance plan requirements are meagre in any event, with the result that many compliance plans are couched in general terms, rather than tailored to the particular scheme.

A possible argument against Option 3 is that compliance with the Corporations Act and the scheme's constitution is an essential element of the operation of a scheme, not merely one factor to be weighed against other factors. However, it is not possible for legislation to prevent deliberate non-compliance. The answer lies in the regulatory response to that non-compliance. The courts have indicated that they will heavily penalise such behaviour. In *Australian Securities and Investments Commission, in the matter of Chemeq Limited (ACN 009 135 264) v Chemeq Limited*,[425] the Court, in applying the concept of a 'culture of compliance' (discussed in Section 5.2.6 of this paper) to the continuous disclosure provisions, said:

> From the point of view of proper risk management against the possibility of contravention, a conservative approach which favours disclosure is to be preferred. Certainly those who play calculated risk games of non-disclosure in the shadow of the Rules cannot expect indulgence from the courts if their assessments are not accepted.[426]
>
> …
>
> When a corporation takes a calculated risk by intentionally or recklessly failing to disclose material information to the market, it may be inferred that there is a corporate culture which encourages or, at least, tolerates or permits decision-making which expressly or implicitly weighs the benefit of non-compliance against the risk if

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423 Compliance plans and risk management systems both involve the identification of risks (for compliance plans, see RG 132.2, RG 132.10; for risk management systems, see ASIC CP 204 para 9).

424 It has been noted, for instance, that there are no specific obligations on licensees (which includes REs) to mitigate the risk of fraud, only a general obligation to have 'adequate risk management systems': *Compensation arrangements for consumers of financial services: Report by Richard St. John* (April 2012), para 3.51. The requirement to have adequate risk management systems is at s 912A(1)(h).

425 [2006] FCA 936.

426 at [87].

> non-compliance is detected. For such deliberate conduct, the risk associated with re-offending must be set at a high level by high penalties.[427]

The matters that might be provided for in a risk management regime for schemes under this option, and the issues relating to such a regime, would be the same as discussed above under Option 2.

If Option 3 is adopted, consideration needs to be given to the appropriate governance structure for monitoring the enhanced risk management framework. This might involve establishing a committee that has responsibility for overseeing the scheme's approach to risk management, which may be achieved by broadening the role of the current compliance committee, replacing that committee with a risk committee or including risk management as a function of another committee such as an audit committee.[428]

ASIC Consultation Paper 204 *Risk management systems of responsible entities* (March 2013) considered it good practice for REs to establish a designated risk management function and/or a risk management committee.[429] It said that the responsibilities of a risk management committee may generally include:

- assisting the board in developing the risk management system
- implementation of the risk management system throughout the organization
- reviewing the effectiveness of the risk management system
- reporting to the board on breaches of risk tolerance or risk management procedures according to the RE's escalation policy
- reporting to the board about the risk management system and its effectiveness or otherwise.[430]

A risk management committee might also regularly review the risk profile of the scheme's business.

Another issue under Option 3 is whether there should be a requirement for an audit of a scheme's risk management arrangements, to replace the current requirement for an audit of the compliance plan.[431] ASIC CP 204 considered that it was good practice for REs to use internal and/or external audits to review compliance with, and the effectiveness of, their

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427 at [93]. In determining the penalty for a contravention, the court will take into account the existence of compliance systems, including provisions for and evidence of education and internal enforcement of such systems, and remedial and disciplinary steps taken after the contravention and directed to implementing a compliance system or improving existing systems and disciplining officers responsible for the contravention: id at [99] (see also at [96], [112]). See also R Baxt, 'Company law and securities: The importance of a culture of compliance' (2013) 41 *Australian Business Law Review* 106, Criminal Code s 12.3(2)(c), (d). The Criminal Code is in the Schedule to the *Criminal Code Act 1995*.

428 Schemes listed on the ASX must have an audit committee 'to independently verify and safeguard the integrity of their financial reporting' or explain why not: ASX *Corporate Governance Principles and Recommendations with 2010 Amendments* (2nd edition), Recommendation 4.1 and Principle 4. This requirement is maintained in the draft third edition released for comment in August 2013.

429 Proposal D1, draft RG 000.40. ASIC CP 204 recognised that the responsibilities of a risk management committee and a compliance committee may overlap (draft RG 000.41, RG 000.44). The draft regulatory guide in CP 204 said that the board of an RE should foster an environment in which the risk management committee receives support from staff, including access to all aspects of the RE's business that may be subject to risks and authority to carry out its duties effectively (draft RG 000.45).

430 Draft RG 000.43.

431 s 601HG.

risk management systems.[432] It considered that such audits can be important in identifying whether:

- risk management processes have been followed
- risk identification and assessment processes and procedures are effective and implemented
- treatment measures and controls to address material risks are operational and effective
- risk management systems are reviewed regularly, with any weaknesses identified for ongoing improvement.[433]

Question 5.6.1. Should the current governance framework consisting of compliance requirements (including a compliance plan, a compliance committee in certain circumstances and audit of the compliance plan) and risk management requirements be retained (Option 1) and why? What problems and/or inadequacies have been experienced with the current framework and what steps might be taken to overcome them?

Question 5.6.2. Alternatively:

- should risk management requirements be introduced specifically for schemes, to operate alongside the compliance requirements for schemes and link in with the risk management licensing obligation of the RE (Option 2) and why, or
- should the current compliance requirements be abolished, with compliance to be covered as part of a risk management regime for schemes that could link in with the risk management framework for the REs that operate them (Option 3) and why?

Question 5.6.3. If Option 1 or Option 2 is adopted, should one or more of the following changes (or some other change and, if so, what) be made to the compliance plan requirements:

- remove the liability of the RE and its officers for non-material breaches of the compliance plan to encourage more detailed plans
- define 'compliance plan' in the Corporations Act so that it covers all the company's documents that deal with compliance with the law
- prescribe additional (or alternative) matters that must be included in the compliance plan?

Question 5.6.4. If additional matters are prescribed, what should those matters be?

Question 5.6.5. If alternative matters are prescribed, which of the matters stipulated in s 601HA should be replaced and with what?

Question 5.6.6. If a risk management regime for schemes, to operate in conjunction with the compliance regime, is introduced (Option 2) or if compliance is merged into a risk management regime for schemes (Option 3):

- what should the elements of the risk management regime be
- should the legislation itself set standards for each of these elements or, alternatively, require that the RE set standards for each element

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[432] Proposal D1.
[433] CP 204 para 45, draft RG 000.81.

- should the risk management regime be in writing
- should the risk management regime include specific requirements for particular types of risk and, if so, what risks should be subject to specific requirements and what should those requirements be?

Question 5.6.7. If Option 2 or Option 3 is adopted, how should the scheme's risk management arrangements be supervised? For instance, should a risk committee or an audit committee supervise those arrangements and, if so, what governance arrangements should apply to such a committee?

Question 5.6.8. If Option 2 or Option 3 is adopted, should there be a requirement for an audit of the scheme's risk management arrangements?

Question 5.6.9. Under any of the options, what potential is there for duplicated or inconsistent regulation where the RE:

- is listed in its own right
- is prudentially regulated by the Australian Prudential Regulation Authority

and how might any duplication or inconsistency be avoided?

Question 5.6.10. What transitional arrangements might be required if Option 2 or Option 3 is adopted?

Question 5.6.11. Should the oppression remedy and/or the statutory derivative action procedure be available to members of a scheme in relation to the RE of the scheme and why?

5.7 Investment guidelines

5.7.1 Guidance rather than requirements

Investment guidelines, indicating how scheme property will be invested and based on a scheme's risk profile, might form an important part of any risk management system for schemes that involve the ongoing investment of funds. For instance, the investment guidelines for an unlisted property scheme might include:

- a liquidity limit, aimed at ensuring that the scheme has sufficient liquid funds to enable it to make suitable acquisitions as the opportunity arises, or
- percentage restrictions on the location of properties or the types of tenant.

The guidelines for most schemes constitute guidance only, so that the schemes have the flexibility to respond to circumstances from time to time, including the prevailing market conditions. Departure from a guideline may be beneficial for the overall investment strategy of a scheme in a particular case to enable the scheme to make an advantageous property acquisition, on the basis that the scheme will subsequently adjust its investment portfolio to restore compliance with the relevant guideline. Investor protection in these situations might be safeguarded by ensuring that the committee with responsibility for overseeing the scheme's approach to risk management supervises this process. This supervisory role would be important, as it may take some time to reweight the portfolio in some instances and it may not be possible to specify the time required.

Replacement of the current compliance framework with a risk–based framework may facilitate this flexible approach to investment guidelines. Currently, ASIC's guidance on

compliance plans takes a strict approach, stating that one of the minimum requirements for a compliance plan would be ensuring that there is adherence to the scheme's investment policy.[434]

A governance structure that may assist to give investment guidelines force, while maintaining flexibility and avoiding confidentiality concerns, would be to require that a committee such as a risk committee or an audit committee review proposed investments:

- to certify that the investments are in accordance with the guidelines, or
- to approve the investments, notwithstanding their departure from the guidelines, either outright or subject to conditions.

In addition, any auditor who is part of the governance framework could check whether scheme investments are in accordance with the investment guidelines.

5.7.2 Disclosure

Investment guidelines, including gearing ratios, may currently need to be disclosed in a Product Disclosure Statement, as being one of the 'significant characteristics or features of the product'.[435] Presumably, the PDS would need to make clear that the guidelines might be departed from in appropriate circumstances where that is the case.

It may be preferable for the Corporations Act to contain a clear and specific requirement to disclose a scheme's investment guidelines.[436] Disclosure of those guidelines would give investors the opportunity to consider whether the scheme's investment strategy is compatible with their own investment goals. Any departure from previously disclosed guidelines, and the reasons for the change, should also be disclosed, to ensure that investors continue to have the information necessary to decide whether investment in the scheme remains appropriate for them. This requirement to disclose departures from investment guidelines could cover a complete change of investment strategy, as well as temporary departures from existing guidelines for a specific purpose. Disclosure of a departure from, or change to, the guidelines would complement the supervisory role that a committee might play in these circumstances.

An argument against a disclosure requirement is that it may detract from commercial confidentiality and assist a scheme's competitors. However, most market participants are aware of the investment guidelines and weightings of their competitors.

A disclosure requirement would be in accordance with the approach recommended by the International Organization of Securities Commissions.[437]

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434 RG 132.12(d).

435 s 1013D(1)(f).

436 The ALRC/CASAC report recommended that:
- the disclosure document for a scheme require disclosure of all the kinds of investments authorised by the scheme's constitution (para 5.14)
- the annual report of a scheme include the investment policy of the scheme and the scheme's performance against that policy, as well as any material change in the investment policy (para 5.27).

That report envisaged the disclosure document for schemes being a prospectus (paras 5.9-5.21). Disclosure is examined in more detail in Chapter 10 of this paper.

437 *Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (September 2011), Principle 26, Methodology Key Questions 5(i) and 12. See further the discussion in Section 14.2 of this paper (Item 7).

Question 5.7.1. Should there be an express requirement for schemes that involve the ongoing investment of members funds to have investment guidelines?

Question 5.7.2. Should departure from any investment guidelines be permitted in some cases and, if so, subject to what safeguards (for instance, approval by a risk committee)?

Question 5.7.3. Should the RE be required to disclose the scheme's investment guidelines and any changes to, or departure from, those guidelines and, if so, how?

Question 5.7.4. Should a committee (for instance, a risk committee or an audit committee) be given a role in relation to investment guidelines, for instance to certify that a proposed transaction is in accordance with the guidelines or to approve a transaction that departs from the guidelines, either outright or subject to conditions? If so, what governance arrangements should apply to such a committee?

6 Scheme constitution

This chapter discusses what rights and powers should be specified in a scheme constitution if they are to exist, the enforceability of scheme constitutions and the procedure for changing them.

6.1 Rights and powers requiring inclusion in the constitution if they are to exist

The issue

Are there any types of right or power in relation to schemes that should only be permitted to exist if specified in a scheme's constitution, but that currently do not need to be so specified?

Current position

The following rights and powers must be included in a scheme's constitution if they are to exist:

- the rights (if any) that the RE is to have to be paid fees out of scheme property, or to be indemnified out of scheme property for liabilities or expenses incurred in relation to the performance of its duties
- the powers (if any) that the RE is to have to borrow or raise money for the purposes of the scheme
- the right (if any) that members are to have to withdraw from the scheme and the procedures for dealing with withdrawal requests.[438]

Analysis and discussion

The constitution is one of the key governance documents of a scheme (the other being the compliance plan, which is intended to ensure compliance with the constitution as well as with the Corporations Act). The rights and powers that can only exist if set out in the scheme constitution might be seen as being such fundamental matters of scheme governance that they should have to be contained in the constitution and not in some other document (such as a separate contractual arrangement or a disclosure document). Inclusion in the constitution would also ensure that the specified rights and powers cannot be varied without following the stipulated statutory procedure (generally a members' special resolution: the procedure for changing a scheme constitution is discussed in Section 6.3 of this paper).

An additional matter that might require inclusion in the constitution is a power of the RE to grant a security over scheme property. If a power to borrow money has to appear in the

[438] s 601GA(2)-(4). ASIC has stated that 'it is not sufficient to merely state in the constitution that the key elements of the withdrawal procedures are set out in a separate document, such as a PDS' (ASIC Regulatory Guide 134 *Managed investments: Constitutions* at RG 134.156). Similarly, an RE's discretion to suspend the right to withdraw from a scheme should be set out in the scheme's constitution, not in another document (RG 134.165).

constitution if it is to exist (as under the current law), it is logical that a right to grant security for the repayment of money so borrowed should also have to appear in the constitution. In practice, the REs of some schemes have given security over the scheme property of those schemes to support a guarantee for another entity (for instance, a related party) to raise money.

Question 6.1.1. What rights and powers, if any, not currently requiring specification in a scheme constitution should be required to be so specified if they are to exist (for instance, an RE's power to grant security over scheme property)?

6.2 Enforceability of the scheme constitution

The issues

Should scheme constitutions be enforceable in the same way as company constitutions?

Current position

A scheme constitution does not receive legal enforceability by force of the Corporations Act. Instead, the Corporations Act requires that the constitution of a registered scheme be contained in a document that is legally enforceable as between the members and the RE.[439] It is uncertain whether this requirement extends to requiring that the constitution be enforceable between the members among themselves.[440]

By contrast, if a company has a constitution, the Corporations Act provides that it has effect as a contract:

- between the company and each member
- between the company and each director and company secretary
- between a member and each other member.[441]

Analysis and discussion

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

There is no apparent policy reason why a scheme constitution should not be enforceable in the same way as a company constitution, that is, by virtue of the Corporations Act and between all relevant parties (not just between the RE and scheme members).

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439 s 601GB. Regulatory Guide 134 *Managed investments: Constitutions* (February 2014) at RG 134.205-RG 134.215 gives guidance on the matters that ASIC takes into account in assessing compliance with this provision.

440 P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶23-200, ¶65-400. Under the general law, a public unit trust deed would not usually be directly enforceable at the suit of another unitholder: HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [1.370.3], citing *Perpetual Trustees WA Ltd v Corporate West Management Ltd* (1988) 13 ACLR 568 at 578, *AF & ME Pty Ltd v Aveling* (1994) 14 ACSR 499, 12 ACLC 831.

441 s 140.

If the SLE Proposal is not adopted,[442] the Corporations Act could provide that a scheme constitution has effect as a contract between all the relevant parties, being each scheme member, the RE and each director and company secretary of the RE. If the SLE Proposal is adopted, the relevant parties to the legislative contract would also include the MIS.

The Turnbull Report recommended that a scheme constitution should be enforceable between the members and the RE by virtue of the Corporations Act.[443] That report noted that:

> ASIC is aware of some constitutions which do not appear to be legally binding. Some of these were constitutions 'converted' from trust documents during the transitional period for the new legislation …
>
> Given this, it is considered that legislative amendments to make scheme constitutions legally binding and enforceable by virtue of the [managed investment provisions of the Corporations Act] … are necessary to guard against an erosion of investors' rights and the efficacy of schemes generally.[444]

CAMAC does not anticipate any costs for schemes if the Corporations Act were changed to ensure that scheme constitutions are enforceable by all relevant parties against all other relevant parties. Any inconsistent provisions of scheme constitutions would simply be overridden by the Act.

Question 6.2.1. How common is it for scheme constitutions to fail to provide that they are legally enforceable by all relevant parties against all other relevant parties?

Question 6.2.2. Are there any instances of scheme members experiencing difficulties through being unable to enforce the scheme constitution against other members?

Question 6.2.3. Are there any reasons why the approach to the enforceability of scheme constitutions should not be the same for schemes as for companies?

6.3 Procedure for changing the scheme constitution

The issue

Should the procedure for changing the constitution of a scheme be the same as that for changing the constitution of a company?

Current position

The constitution of a registered scheme may be modified, or repealed and replaced with a new constitution:

- by special resolution of the members of the scheme[445] (this is the same as the procedure for modifying or repealing a company's constitution[446]), or

442 The SLE Proposal is summarised in Section 1.1.1 of this paper.
443 rec 5.
444 Section 2.5.
445 s 601GC(1)(a).

- by the RE unilaterally if the RE reasonably considers the change will not adversely affect members' rights (there is no equivalent means for amending a company's constitution).[447]

A modification to the constitution does not take effect until a copy of the modification has been lodged with ASIC.[448]

There has been considerable judicial consideration of the provision enabling the RE to modify a scheme's constitution.

The RE's task when contemplating exercise of this power is set out in *ING Funds Management Ltd v ANZ Nominees Ltd; ING Funds Management Ltd v Professional Associations Superannuation Ltd*:

- the RE must first ascertain the rights of members created by the constitution, as they exist immediately before the modification
- the RE must then decide whether those rights (as distinct from the enjoyment of them or their value) will be changed or impinged upon by the modification
- if the RE decides that the rights will be so affected, it must undertake a process of comparison and assessment to decide whether the impact 'adversely affects' members' rights.[449]

The RE can exercise this power if it 'reasonably considers' that the modification will not adversely affect members' rights. The Court in the *ING* case said that the expression 'reasonably considers':

- has the same meaning as 'considers on reasonable grounds' or 'believes on reasonable grounds'

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446 s 136(2). A special resolution requires the approval of 75% of the votes cast by those entitled to vote on the resolution: definition of 'special resolution' in s 9. The analogy between the procedure for amending a scheme constitution and the procedure for amending a company constitution and debenture trust deeds is discussed in *ING Funds Management Ltd v ANZ Nominees Ltd; ING Funds Management Ltd v Professional Associations Superannuation Ltd* [2009] NSWSC 243 at [56]-[59].

447 s 601GC(1)(b). The term 'members' rights' in s 601GC(1)(b) includes the members' contractual and equitable rights provided in the constitution: *Smith v Permanent Trustee Australia Ltd* (1992) 10 ACLC 906 at 913-914; *ING Funds Management Ltd v ANZ Nominees Ltd; ING Funds Management Ltd v Professional Associations Superannuation Ltd* at [94]; *Premium Income Fund Action Group Incorporated v Wellington Capital Limited* [2011] FCA 698 at [34], *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [656].

448 s 601GC(2). The Court in *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [27], and again at [673], rejected the contention that, even if not validly made, amendments to a scheme constitution become effective upon lodgement with ASIC and remain so until they are declared invalid. The Court in that case held (at [445]) that the purpose of lodgement with ASIC pursuant to s 601GC(2) was to ensure that:

- there is certainty about the contents of scheme constitutions
- ASIC holds the current constitution of each scheme in its records in order to satisfy itself that the constitution complies with the Corporations Act and/or so that it can deal with enquiries or complaints in regard to compliance
- the members can have ready access to the scheme's constitution and be certain that it is current.

The Court also said that:

> The section promotes transparency and accountability by an RE in relation to the primary legal instrument of the scheme. It is intended to protect the members' interests and promotes the efficient regulation of managed investment schemes (ibid).

449 [2009] NSWSC 243 at [96]. See also at [100].

- requires that:
  - the relevant belief or opinion be actually held by the RE
  - facts exist that are sufficient to induce the belief or opinion in a reasonable person.[450]

While these principles from the *ING* case have been applied in subsequent cases,[451] another aspect of that case has not been followed. The Victorian Court of Appeal in *360 Capital Re Ltd (ACN 090 939 192) v Watts (as trustees for the Watts Family Superannuation Fund)* held that members' rights include a right to have the managed investment scheme operated and administered according to the constitution as it stands and that an RE must therefore consider this right when contemplating a change in a scheme constitution.[452] The Court of Appeal rejected[453] the contrary view in the *ING* case.[454]

Analysis and discussion

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

The Explanatory Memorandum to the Bill for the *Managed Investments Act 1998* gave no reason for giving the RE of a scheme the power to alter the scheme constitution in the stipulated circumstances.[455] The Court in one case said that the power 'is designed to protect the rights of members of registered schemes while permitting responsible entities to amend the constitutions of schemes in ways that they reasonably consider do not adversely affect members' rights, without the inconvenience and expense of convening meetings of members'.[456] However, it is not readily apparent that this rationale provides a relevant point of distinction between schemes and companies.

A company constitution has effect as a contract between various parties[457] and can only be changed by special resolution of members.[458] There is no apparent policy reason why the nature of a scheme constitution and the procedure for changing it should be any different.

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450 at [102]. See also *Re Great Southern Managers Australia Limited (recs & mgers app't) (in liq)* [2009] VSC 627 at [19].

451 *Re Great Southern Managers Australia Limited (recs & mgers app't) (in liq)* [2009] VSC 627 at [18], *Re Timbercorp Securities Limited (in liq)* [2010] VSC 50 at [7], *Premium Income Fund Action Group Incorporated v Wellington Capital Limited* [2011] FCA 698, *Re Centro Retail Ltd* [2011] NSWSC 1175 at [17], *Re Elders Forestry Management Ltd* [2012] VSC 287 at [53]-[58], *Watts & Watts v 360 Capital Re Limited* [2012] VSC 320 at [26], [41].

452 [2012] VSCA 234, approved in *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [449], [658]-[659], [668]. The Court of Appeal endorsed the decision of the Court at first instance (*Watts & Watts v 360 Capital Re Limited* [2012] VSC 320) and approved the decision on this point in *Premium Income Fund Action Group Incorporated v Wellington Capital Limited* [2011] FCA 698. The constitutional amendment in the *360 Capital* case would have permitted the issue of redeemable unsecured convertible notes. The constitutional amendment in the *Premium Income* case would have changed the method for determining the issue price of a unit in the scheme.

453 at [25]-[45].

454 [2009] NSWSC 243 at [98]. See also *Re Centro Retail Ltd* [2011] NSWSC 1175, particularly at [35].

455 The discussion of the provision for changing a scheme constitution in the Explanatory Memorandum to the Bill for the *Managed Investments Act 1998* (paras 9.6-9.9) mentions this power, but does not explain the rationale for it.

456 *Watts & Watts v 360 Capital Re Limited* [2012] VSC 320 at [40].

457 s 140.

458 s 136(2). A special resolution requires the approval of 75% of the votes cast by those entitled to vote on the resolution: definition of 'special resolution' in s 9.

If the scheme constitution is treated as a contract between the involved parties, it would be unusual to permit one party to the contract (the RE) to change it unilaterally.

Question 6.3.1. What difficulties, if any, have been experienced as a result of the current procedure for amending scheme constitutions?

Question 6.3.2. Is there any reason why the procedure for changing a scheme constitution should differ from that for amending a company's constitution?

Question 6.3.3. If the procedure for amending a scheme constitution should differ from that for amending a company's constitution, does the current procedure for schemes (in particular the ability of the RE to amend the constitution where the RE reasonably considers that the amendment would not adversely affect members' interests) need to be modified and, if so, how?

7 The responsible entity and others involved in the operation of a scheme

This chapter considers the duty of REs to treat scheme members equally and the entitlement of REs to fees and indemnities, as well as their liability for the acts and omissions of their agents. It discusses the disclosure of interests of directors of the RE and the scope of the related party transaction provisions applicable to schemes. It also raises for consideration the possibility of simplifying the procedure for replacing the RE in some circumstances. Finally, it examines the place of scheme custodians in the regulatory framework.

7.1 Duty to treat members equally

The issue

Should the obligation for an RE to treat members of the same class equally and members who hold interests of different classes fairly be replaced with an obligation for an RE to treat all members fairly?

Current position

In exercising its powers and carrying out its duties, the RE of a registered scheme must treat the members who hold interests of the same class equally and members who hold interests of different classes fairly.[459] The legislation does not define what is meant by a 'class'.[460]

The duty to treat members of the same class equally prevents an RE from charging differential fees to members of the same class. However, ASIC provides class order relief from this equal treatment provision to permit some differential fee arrangements by reference to such matters as:

- the total value, or the number, of interests in the scheme held by a member
- the total period of time during which the member held interests in the scheme
- the member's use of electronic trading and communications.[461]

Analysis and discussion

An obligation for the RE to treat members of the same class 'fairly' may provide REs with more flexibility than the current obligation to treat those members 'equally'.

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459 s 601FC(1)(d). The ALRC/CASAC report at para 2.8 refers to the 'need to ensure that, if investors are divided into classes, investors in one class are treated fairly compared with those in another class'.

460 This paper discusses in Section 16.1 whether the Corporations Act should be amended to provide further detail about what constitutes a class of interests in a managed investment scheme.

461 ASIC Class Order [CO 03/217]. Other situations where the Class Order permits differential fees are the member being an employee of the RE or a related body corporate, the member having acquired the interests in the scheme under a switching facility that involved the member withdrawing from another scheme operated by the RE and savings to the scheme arising from particular characteristics of the member.

A particular example of the administrative flexibility that would be afforded to REs by such a change is the ability to charge differential fees, which have been the focus of the reform proposals that have been made to date in this area.[462]

Question 7.1.1. Should the RE's obligation to treat members of the same class 'equally' be replaced with an obligation to treat those members 'fairly'?

Question 7.1.2. Are there any reasons why such a change should not be made?

Question 7.1.3. Should such a change be accompanied by any consequential amendments (for instance, disclosure to investors of relevant details about differential fee arrangements)?

7.2 RE's entitlement to fees and indemnities

The issue

It is not always clear what is entailed in the concept of 'proper performance' of an RE's duties in relation to an RE's entitlement to fees and indemnities.

Current position

An RE only has the right to be paid fees out of scheme property, or to be indemnified out of scheme property for liabilities or expenses incurred in relation to the performance of its duties, if two conditions are satisfied:

- the right must be specified in the scheme's constitution, and
- the right must be available only in relation to **the proper performance of the RE's duties**.[463]

The Corporations Act does not elaborate on the meaning of 'proper performance'.

Analysis and discussion

Circumstances in which it is unclear whether the 'proper performance' requirement is satisfied (and the RE is therefore entitled to fees and indemnities) include:

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462 Turnbull Report rec 15; the Parliamentary Joint Committee on Corporations and Financial Services report on the Turnbull Report, *Report on the Review of the Managed Investments Act 1998* (2002) rec 15. The Turnbull Report recommended that the right to charge differential fees should be subject to a requirement that investors be provided with adequate disclosure to allow them to compare the effect of differential fee arrangements. ASIC's second submission to the Turnbull Review said that this disclosure should cover:
- different fee structures available from the one offeror
- the effect of differential fee structures as between different offerors.

The Turnbull Report recommendation favoured further consideration being given to whether there is also a need for the fairness 'test' to be interpreted by reference to some other criterion such as economic justification, and whether any interpretational material supporting the fairness test should be located in legislation or in ASIC policy. ASIC's second submission to the Turnbull Review gave as an example of an economic justification criterion that a differential fee arrangement must be reasonable having regard to the difference between:
- the cost incurred by the RE in providing services to any member who is a party to a differential fee arrangement, and
- the cost incurred in providing services to any member who is not a party to the arrangement.

463 s 601GA(2).

- where the RE has properly performed some duties in relation to the scheme (in the sense that the RE's actions do not constitute a breach of the relevant duties), but has not properly performed other duties

- where the RE has breached its duties in relation to the scheme, but has subsequently remedied the breaches.

Furthermore, it is unclear whether the concept of 'proper performance' is limited to the mere absence of breach or extends to situations where an RE's performance of its duties is not to an appropriate standard, even though it has not breached any of those duties.

There are several options for clarifying the law in this area.

Option 1: require proper performance of all duties

The law might provide that an RE is only entitled to a fee or a right of indemnity or reimbursement if all the RE's duties are performed without any breach. This option may encourage a higher standard of behaviour on the part of REs.

Option 2: entitlement in relation to duties properly performed

The law might provide that an RE is entitled to a fee or a right of indemnity or reimbursement for work that is done in the proper performance of its duties and does not involve a breach, even if other work has involved a breach of duty.

This option may be preferable to the 'all or nothing' approach represented by Option 1, as it may provide a continuing incentive for an RE to strive to perform its duties properly, even though it has previously committed a breach.

Option 3: require proper performance of all duties but permit atonement

This option would be a variation on Option 1.

The law might provide that an RE is only entitled to a fee or a right of indemnity or reimbursement if there is no outstanding breach in relation to any of the RE's duties. However, in contrast with Option 1, this result could be achieved by permitting the RE:

- to remedy any breach, including by way of set-off, or

- to indemnify every member and former member for any loss caused by the breach.

This option would provide an incentive for the identification and rectification of breaches and alleviate the strict approach represented by Option 1.

Option 3 would raise the further question whether any reinstated entitlement following on from the remedy of a breach should cover fees and expenses incurred during the period of breach. Excluding amounts relating to that period would provide REs with an additional incentive to perform their duties properly.

Option 4: entitlement in relation to duties properly performed, including by atonement

This option would be a variation on Option 2.

The law might provide that an RE is entitled to a fee or a right of indemnity or reimbursement for work in relation to which there is no outstanding breach, even if breaches remain in relation to other work. However, as with Option 3, but in contrast with Option 2, this result could be achieved by permitting the RE:

- to remedy any breach, including by way of set-off, or
- to indemnify every member and former member for any loss caused by the breach.

This option may provide a greater incentive for the identification and rectification of breaches than Option 3, as it would enable the RE to claim payment for fees or indemnification for liabilities or expenses on a progressive basis, rather than having first to identify and rectify all breaches.

The further question raised under Option 3 concerning the coverage of any reinstated entitlement would apply equally to Option 4.

Option 5: clarify the standard entailed in the concept of 'proper performance'

The law might be amended to clarify that proper performance of duties means performance to a specified standard, rather than merely the absence of any breach.

A clarification along these lines would not deal with the questions at which Options 1 to 4 are directed (the consequences where some duties have been properly performed but not others or where a breach has been remedied).

However, if the specified standard were applied in determining proper performance, Options 1 to 4 could be restated as follows:

- *Option 1:* an RE is only entitled to a fee or a right of indemnity or reimbursement if all the RE's duties have been performed to the specified standard
- *Option 2:* an RE is entitled to a fee or a right of indemnity or reimbursement for work done in the performance of duties to the specified standard, even if other work does not satisfy that standard
- *Option 3:* as for Option 1, but with the ability for the RE to satisfy the specified standard by taking remedial action
- *Option 4:* as for Option 2, but with the ability for the RE to satisfy the specified standard by taking remedial action.

Question 7.2.1. What issues have arisen in practice in relation to the concept of 'proper performance' of an RE's duties?

Question 7.2.2. If clarification of the meaning of 'proper performance' is required, which of the options mentioned above should be adopted? Alternatively, should some other option be adopted and, if so, what?

Question 7.2.3. If Option 3 or Option 4 is adopted, should any restored entitlement to fees or rights of indemnity or reimbursement extend to amounts relating to the period of the breach?

Question 7.2.4. If Option 5 is adopted, what standard for determining 'proper performance' should be specified?

7.3 Attribution to the responsible entity of acts or omissions of persons engaged to perform the responsible entity's functions

The issues

The Corporations Act only attributes to the RE acts or omissions of an agent, or other person engaged by the RE, for two purposes:

- determining the RE's liability to members
- determining whether the RE has properly performed its duties for the purpose of establishing its right to be paid fees, or to be indemnified, out of scheme property.

The issues considered in this section are:

- for what purposes or in what circumstances, if any, should the acts or omissions of an agent be attributed to the RE
- what continuing liability should an RE have for losses arising from acts or omissions of its agent once amounts have been recovered from the agent to cover those losses.

Current position

The RE of a registered scheme has the responsibility for operating the scheme and performing the functions conferred on it by the scheme's constitution and the Corporations Act.[464]

The RE can engage other persons to perform any of its functions in connection with the scheme.[465] For this purpose, the RE can:

- appoint an agent, or
- otherwise engage a person.

This power of the RE is wider than that of a trustee at general law, under which trustees:

- are not entitled to cast upon others the duty of performing the trusts and exercising the judgment and discretion that they are bound to perform and exercise themselves, but
- are entitled to employ others when it would be in the ordinary course of business to do so and they use due diligence in selecting their agents.[466]

One example of a person that the RE may engage is a custodian to hold scheme property.[467] Other parties that an RE may want to engage include investment managers, property managers, back-office service providers and providers of registry services.[468]

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464 s 601FB(1).

465 s 601FB(2). Where a person engaged by the RE engages another person, that other person is taken to be an agent appointed by the RE to perform its functions (s 601FB(3)).

466 *Re Speight* (1883) 22 Ch D 727 at 744, 756, 762–763.

467 Explanatory Memorandum to the Bill for the *Managed Investments Act 1998* para 8.5. Custodians are discussed further in Section 7.7 of this paper.

468 P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶30-300.

The wide power for an RE to engage other persons to perform its functions is balanced by a provision that attributes to the RE acts or omissions of those persons for certain purposes. The RE is taken to have done (or failed to do) anything that an agent or other person has done (or failed to do) (even if the agent or other person was acting fraudulently or outside the scope of his or her authority or engagement) for the purpose of determining whether:

- there is a liability to the members, or
- the RE has properly performed its duties for the purposes of establishing its right to be paid fees, or to be indemnified, out of scheme property[469] (the question of what constitutes 'proper performance' of an RE's duties is considered in Section 7.2 of this paper).

This liability of the RE overrides provisions under State and Territory legislation that would only impose liability on an RE, as a trustee, for its own default.[470] It 'places the onus upon the responsible entity to make good to scheme members any losses suffered by a scheme as a result of the conduct of persons engaged by the responsible entity in relation to the scheme'.[471]

The legislation makes provision for the respective liabilities of the RE and its agent.

Subsection 601FB(4) provides that:

> If:
>
> (a) an agent holds scheme property on behalf of the responsible entity; and
>
> (b) the agent is liable to indemnify the responsible entity against any loss or damage that:
>
> (i) the responsible entity suffers as a result of a wrongful or negligent act or omission of the agent; and
>
> (ii) relates to a failure by the responsible entity to perform its duties in relation to the scheme;
>
> any amount recovered under the indemnity forms part of the scheme property.

However, Corp Reg 5C.11.06 provides that:

> In determining the liability under subsection 601FB(2) of the Act of the responsible entity of a registered scheme to the members of the scheme for an act or omission of an agent appointed by the entity under that subsection, the amount recovered under subsection 601FB(4) of the Act is to be disregarded.

There is an issue concerning the interaction of these two provisions. It has been stated that the intention of this regulation is 'to prevent the possibility of compensating the managed

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469 ss 601FB(2), 601GA(2).

470 *Trustee Act 1925* (ACT) s 59, *Trustee Act 1925* (NSW) s 59, *Trustee Act* (NT) s 26, *Trusts Act 1973* (Qld) s 71, *Trustee Act 1936* (SA) s 35, *Trustee Act 1898* (Tas) s 27, *Trustee Act 1958* (Vic) s 36, *Trustees Act 1962* (WA) s 70. The language giving rise to the trustee's liability varies from jurisdiction to jurisdiction: 'own wilful neglect or default' (ACT, NSW), 'own wilful default' (NT, Tas, Vic, WA), 'own acts, receipts, neglects or defaults' (Qld), 'own wrongful or negligent act or omission' (SA).

471 Explanatory Memorandum to the Bill for the *Managed Investments Act 1998* para 8.6.

investment scheme twice for an act or omission by an agent appointed by the responsible entity'.[472] However, the regulation appears to have the opposite effect.

Analysis and discussion

Purposes for which acts or omissions are attributed to the responsible entity

In principle, the attribution to the RE of acts and omissions of its agent may enhance investor protection (including by providing REs with an incentive to choose suitable agents and closely monitor their activities).

For the most part, the first purpose for which attribution may occur (the determination of liability to members) appears largely to satisfy this investor protection goal. Attribution for this purpose means that members who have suffered loss through the acts or omissions of the RE's agent do not have to identify and pursue that agent, but rather can take action against the RE itself as the operator of the scheme. However, a possible limitation from the investor protection point of view is that the current provision would not attribute to the RE acts or omissions of its agent for the purpose of determining liability to:

- prospective investors who for some reason fail to become scheme members,[473] or
- persons who have ceased to be members.

Furthermore, in relation to proper performance of an RE's duties, it appears to be unduly restrictive to limit attribution to the determination of the RE's entitlement to fees and indemnities. Investor protection, particularly the provision of an incentive to choose appropriate agents, may be enhanced by permitting attribution of an agent's acts or omissions to the RE in all matters relating to the proper performance of its duties[474] or, more widely, in all instances, regardless of the matter in question.

Continuing liability of the responsible entity

Given that the effect of Corp Reg 5C.11.06 appears to be the opposite of that intended, it may be advisable to clarify the law. Any legislative clarification might be facilitated if the relevant law were contained solely in the Corporations Act: it is unnecessarily complex to have the provisions determining the quantum of the RE's liability split between the Corporations Act and the Corporations Regulations.[475]

Question 7.3.1. For what purposes, or in what circumstances, should an RE be liable for the acts and omissions of its agents?

Question 7.3.2. Are there any reasons why liability should not be imposed on REs for the acts and omissions of their agents in all instances?

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472 Explanatory Statement to Corporations Regulations (Amendment) 1998 No. 186, reg 13.

473 For instance, where an intended issue of interests in the scheme proves to have been invalid, the persons who would have held the interests are not members: see *Watts & Watts v 360 Capital Re Limited* [2012] VSC 320 at [72].

474 For instance, attribution would be appropriate for determining whether an RE:
- has exercised the requisite degree of care and diligence (s 601FC(1)(b)), or
- has adequate arrangements to manage conflicts of interests (s 912A(1)(aa)).

475 The Turnbull Report (Section 5.2.8) took this view, as did the ASIC submission at Stage 1 of the CAMAC review.

Question 7.3.3. Does the current law adequately prevent the possibility of double compensation for an act or omission by an RE's agent and, if not, how should the law be clarified?

7.4 Disclosure of interests of directors of the responsible entity

The issue

If a managed investment scheme is listed, but the RE is not, the directors of the RE are not subject to the same disclosure requirements as directors of listed companies.[476]

Current position

Section 205G requires directors of a listed company to notify the relevant market operator, among other things, of:

- their interests in securities of the company or related bodies corporate, and
- contracts that confer rights to interests in managed investment schemes made available by the company or related bodies corporate.

This obligation does not apply to the directors of the RE of a listed scheme where the RE itself is not listed.

The Turnbull Report noted[477] that the predecessor of s 205G contained a requirement for disclosure in situations where the scheme was listed but not the RE.[478] It appears that this requirement was inadvertently omitted when the section was amended.[479]

Analysis and discussion

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

There appear to be no sufficient reasons for treating schemes differently in this instance. The omission of directors of scheme REs from this disclosure requirement appears to have been unintentional.

The Turnbull Report favoured an amendment to rectify this omission.[480]

Question 7.4.1. Should the requirements for disclosure of interests of directors of REs of listed schemes be brought into line with the disclosure requirements in this area for listed companies?

476 Turnbull Report Section 5.2.2.
477 ibid.
478 Former s 235(1A).
479 By the *Corporate Law Economic Reform Program Act 1999*.
480 Section 5.2.2 and rec 17.

7.5 Related party transactions

The issues

The related party provisions for schemes may be too wide, in particular where agents of a person engaged by an RE are treated as related parties.

Should an RE's contravention of the related party provisions attract criminal liability?

Current position

Related party transaction provisions were introduced for public companies by the *Corporate Law Reform Act 1992* to protect shareholders against the possibility 'that the value of their investment would be eroded by a party related to the company arranging for the company to enter into a transaction which gives a benefit to the related party'.[481] The provisions 'only prevent transactions with related parties with the potential to adversely affect shareholders' interests, not full value commercial transactions'.[482]

With the introduction of Chapter 5C, the related party transaction provisions were applied to registered schemes 'to prohibit a responsible entity from providing a financial benefit to a related party that could diminish or endanger scheme property'.[483]

The giving of a financial benefit in relation to a registered scheme is governed by a procedure having the following features:[484]

- *donor of the benefit:* the benefit is given by:
  - the RE
  - an entity[485] that the RE controls,[486] or
  - an agent of, or person engaged by, the RE
- *source or effect of the benefit:* the benefit is given out of, or could endanger, scheme property
- *donee of the benefit:* the donor and the donee are the same person or the benefit is given to:
  - a related party of the donor, or
  - one of the persons falling within the above category of *donor of the benefit* or a related party[487] of such a person

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481 Explanatory Memorandum to the Bill for the *Managed Investments Act 1998* para 13.2.
482 ibid.
483 id at para 13.3. The ALRC/CASAC report recommended the application of related party provisions to schemes (paras 10.23-10.25). The application of the related party provisions to schemes was considered in *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342, particularly at [701]-[734].
484 Replacement s 208(1), (2) introduced into the related party provisions by s 601LC.
485 As defined in s 191.
486 As defined in s 191.
487 As defined in s 228.

- *conditions for giving the benefit*: either:
  - the *donor of the benefit* must obtain the approval of the scheme's members in the way set out in ss 217 to 227 and give the benefit within 15 months after the approval (this condition is also satisfied if the members approve the making of a contract that requires the giving of the benefit and the contract was made before, but was conditional on, the approval or was made within 15 months after the approval), or
  - the giving of the benefit must fall within certain exceptions applicable to related party transactions involving companies.[488]

This procedure is not required for the RE to pay itself fees or exercise rights to an indemnity, as provided for in the scheme's constitution under s 601GA(2).[489]

If a benefit is given without satisfying one of the stipulated conditions:

- the relevant contract or transaction is not affected[490]
- the RE is not guilty of an offence[491]
- the RE is not liable to a civil penalty[492]
- persons involved in a contravention of the related party provisions commit an offence if their involvement is dishonest[493] or incur a civil penalty if their involvement is not dishonest.[494]

Analysis and discussion

Scope of the provisions

The related party provisions for schemes were adapted from those for companies, to recognise the structural differences between a company (which exists as a separate legal entity having its own officers and members) and a scheme (which does not constitute a separate legal entity, but rather has an RE, which provides the officers who perform the tasks involved in the operation of the scheme, and members). One commentary summed

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488 Section 601LC refers to the exceptions in ss 210 to 216. However, ss 213 (small amounts given to a related entity) and 214 (benefit to or by closely-held subsidiary) do not apply to schemes (s 601LD). See Explanatory Memorandum to the Bill for the *Managed Investments Act 1998* para 13.4. The onus of proving that a transaction falls within one of these exceptions falls on the defendant: *Waters v Mercedes Holdings Pty Limited* [2012] FCAFC 80 (followed in *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [712]-[716], [721]).

489 Replacement s 208(3) introduced into the related party provisions by s 601LC. The onus of proving that a transaction falls within this exception falls on the defendant: *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [720].

490 s 209(1)(a), applied by s 601LA.

491 s 209(1)(b), applied by s 601LA.

492 Subsection 209(2) (as modified by s 601LA(a)) is the civil penalty provision and only applies to a person involved in a contravention by an RE. The definition of 'involved' in s 79 does cover the person who committed the contravention, in this case the RE. The RE could not, in any event, be a 'person involved' in the context of s 209, as a person dishonestly involved commits an offence under s 209(3), whereas s 209(2), as modified by s 601LA(a), provides that the RE is not guilty of an offence.

493 s 209(3), applied by s 601LA.

494 s 209(2), applied by s 601LA, s 1317E(1)(b).

up the differences between the related party provisions for companies and those for schemes as follows:

> Essentially, s 601LA [the provision that sets out the structural modifications of the provisions applicable to companies for schemes] treats the responsible entity as if it were the public company in the related party provisions, for certain purposes, and for other purposes it treats the members of the scheme as if they were the public company. Thus, while a public company cannot contravene Ch 2E by receiving a benefit, but only by giving it, the extended related party provisions for registered schemes can be contravened if the responsible entity receives or gives a benefit out of the scheme property.[495]

The categories of donees of the benefit who come within the related party provisions for schemes are broader than those for public companies. Related parties of a public company are:

- its directors
- any directors of an entity that controls the public company
- if the public company is controlled by an entity that is not a body corporate - each of the persons making up the controlling entity
- spouses of persons in the first three categories
- parents and children of persons in each of the above categories
- an entity controlled by another related party (unless the entity is also controlled by the public company).[496]

Related parties of public companies do not automatically include, for instance, their agents or persons engaged by them. By contrast, an agent of, or person engaged by, the RE falls within the class of donees of a benefit who are covered by the related party provisions, even if that person is not otherwise related to the RE. This class of regulated donees would include an independent custodian.

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently. The presence of the RE in the scheme structure is a relevant difference that requires some modification of the related party transaction provisions for schemes. However, there is no apparent reason why an agent of, or person engaged by, the RE should be a related party in connection with a scheme when a person in an equivalent position in relation to a company would not be a related party of the company.

Adoption of the SLE Proposal would not make any difference to this issue, as the MIS would not have any directors, officers or employees, which would be provided by the RE, as under the current law.

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495 HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.508].

496 s 228.

Consequences of breach

There are compelling reasons for treating schemes differently from companies in relation to the consequences of breach of the related party transaction provisions.

The corporate related party provisions prohibit the giving of benefits by the company unless the stipulated procedures are followed. The aim is to preserve company property for the benefit of the company itself. There is therefore no need to prohibit the giving of benefits to the company. By contrast, a managed investment scheme is not a separate legal entity. The aim of the related party provisions for schemes is to preserve scheme property for the benefit of scheme members. The related party provisions for schemes therefore prohibit the giving of benefits to the RE as well as by the RE unless the stipulated procedures are followed.

The liability regime for breach of the related party transaction provisions seems not to recognise this difference between companies and schemes. It appears to be inappropriate to give the RE the same exemption from criminal liability and liability to a civil penalty that applies to companies. The RE holds scheme property on trust for scheme members[497] and might reasonably be held liable, both criminally and civilly, for misuse of that property.

One commentary has observed, in relation to the imposition of criminal liability:

> There is no sound policy reason for excluding criminal liability in this context. Section 209(1)(b), as it applies to registered schemes, is inappropriate. The reason why sec 209(1)(b), as it applies to public companies, excludes criminal liability for the company itself is that the company is seen as the victim of the contravention. The financial benefit, in the context of companies, operates to reduce the resources of the public company in favour of the recipient of the benefit and to the detriment of the public company's shareholders. Imposing liability on the company itself would twice punish the shareholders. This argument has no application in the context of registered schemes. Punishing the wrongdoing responsible entity (or other person conferring the benefit) would not harm the interests of the members of the scheme.[498]

It may also be worth reassessing the application to REs of the provision preserving the validity of any contract or transaction connected with the giving of benefit.[499] One possibility is to make such a contract or transaction void (or at least voidable) against the RE, but preserve its validity for third parties.

If the SLE Proposal were adopted, the MIS, like a company, would not be a related party. The RE would continue to be a related party for the purpose of the related party transaction provisions.

Question 7.5.1. Do the related party provisions for schemes need to differ from those for companies and, if so, in what respects and why?

Question 7.5.2. Should the RE be subject to criminal liability and/or civil penalties for breach of the related party provisions?

Question 7.5.3. Where an RE has given a benefit in contravention of the related party provisions, what should be the effect on the validity of the contract or transaction?

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497 s 601FC(2).
498 P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶54-700.
499 s 209(1)(a).

7.6 Change of responsible entity

The issues

There are several circumstances in which the requirement to hold a meeting to change the RE of a scheme might reasonably be dispensed with. However, a change of RE cannot be effected without a meeting of members, unless ASIC grants relief. It may be worth considering whether it would be possible to devise a legislative amendment that could avoid the need to convene a meeting of members to change an RE in appropriate circumstances.

Current position

Corporations Act

An RE of a scheme can retire from that position if a meeting of members chooses another eligible entity to become the new RE.[500] The members may also take action to require the calling of a meeting[501] to consider and vote on a resolution that the current RE be removed and a resolution to choose a new RE.[502]

The RE of a listed scheme may be replaced by two ordinary resolutions of scheme members (one to remove the current RE and another to choose a new RE), being a simple majority of votes cast by members entitled to vote on the resolutions.[503] The RE and its associates may vote any interests they hold as members on those resolutions.[504]

More stringent requirements apply to unlisted schemes. The replacement of an RE of an unlisted scheme requires two 'extraordinary resolutions' of scheme members, being the approval of at least 50% of the total votes that can be cast by members entitled to vote, whether or not cast.[505] Also, the RE and its associates are ineligible to vote on the removal and replacement resolution.[506]

In the 2012 CAMAC report, CAMAC (following on from a recommendation of the Turnbull Report[507]) recommended that the current 'extraordinary resolution' voting requirements for unlisted schemes be replaced with a requirement for simple majorities of the votes of scheme members cast at the meeting (in person or otherwise), provided that the total votes cast (for and against) on each of the resolutions constitute at least 25% of the total votes of scheme members (excluding votes that are ineligible to be voted on the resolution).[508]

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500 s 601FL.
501 Part 2G.4 Div 1.
502 s 601FM.
503 ss 601FM(1), 252L(1B)(c).
504 Where a scheme is listed, the RE and its associates are entitled to vote their interests on resolutions to remove the RE and to choose a new RE: s 253E. This provision is discussed in Section 8.4 of this paper.
505 s 601FM and the definition of 'extraordinary resolution' in s 9.
506 For an unlisted scheme, the RE and its associates are not entitled to vote their interests on resolutions to remove the RE and choose a new RE, as they would have an interest in those resolutions: s 253E. That provision specifically allows the RE and its associates to vote on those resolutions where the scheme is listed.
507 rec 2.
508 Section 5.4.3.

ASIC relief

ASIC grants relief on a case by case basis to permit a change of RE of a registered scheme without the need for a meeting of members in the following circumstances:

- the RE and the proposed replacement RE are members of the same corporate group and there is no significant change to the underlying operation of the scheme. This relief requires the RE to advise members of its intention to resign and the intended appointment of the replacement RE. If a sufficient number of members believe a vote should occur on the resolution to choose a new RE and advise the current RE of this, the RE is required to arrange for a postal vote or convene a meeting to allow members to vote on the resolution to appoint the replacement RE, or
- there is a very small number of members in the scheme (for instance, less than six) and either:
  - all those members would be prevented from voting by having an interest in the resolution other than as a member[509] and had provided their written consent,[510] or
  - those members were wholesale clients and had provided written consent to the change of RE.

Analysis and discussion

It is desirable that the procedures in the Corporations Act be as simple as possible, while protecting the rights of interested parties.

If the circumstances in which ASIC has granted an exemption from the requirement to hold a meeting can be effectively incorporated into the Corporations Act, it would relieve the administrative burden on ASIC and reduce costs for involved parties.

A contrary view is that it may be too difficult for a law of general application to ensure that all parties are protected and the involvement of ASIC in each instance is necessary to take account of the circumstances of each particular case.

Question 7.6.1. Should the Corporations Act allow for the possibility of a change of RE without a meeting of members:

- in the types of circumstances where ASIC has given relief
- in any other circumstances and, if so, what circumstances

and what procedural safeguards should apply?

7.7 Scheme custodians

The issues

Should scheme custodians be subject to the licensing regime, so that ASIC can supervise and regulate their activities directly?

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509 s 253E.
510 See ASIC Regulatory Guide 136 at RG 136.5.

Should the basis on which a custodian holds property on behalf of an RE be clarified?

Should custodians be allowed to hold money to acquire interests in a scheme on behalf of the RE?

Current position

Place of custodians in the regulatory framework

Before the introduction of the managed investment scheme provisions in Chapter 5C, managed investment schemes were regulated as 'prescribed interests',[511] which had a dual structure consisting of a trustee and a management company.

With the introduction of Chapter 5C by the *Managed Investments Act 1998*, this dual structure was replaced by a single responsible entity, which was required to hold an Australian financial services licence (AFSL).[512]

Unless ASIC grants relief, the RE has an obligation to ensure that scheme property is clearly identified as such and held separately from property of the RE and property of any other scheme.[513] Also, where the RE holds scheme property, the property is held on trust for scheme members.[514]

In practice, however, many REs use a custodian to hold scheme property.[515] The PJC Trio report described the role of a custodian as follows:

> A custodian is responsible for the safekeeping of the assets of a third party client such as a managed investment scheme. It holds legal title to the assets of the client. However, as ASIC noted in its submission, 'the custodian only acts on properly authorised instructions from its direct client or authorised agent' and that prime responsibility rests with the RE. Further, custodians are not required to verify underlying assets in managed investment schemes, only the units in these schemes.[516]

The amount of net tangible assets (NTA) that ASIC requires an RE to hold under its licensing conditions is less if the RE uses a custodian that satisfies specified NTA

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511 Former Part 7.12 Div 5.

512 s 601FA, definitions of 'financial service' and 'financial services business' in s 761A, ss 766A(1)(d), 911A.

513 s 601FC(1)(i). For ASIC relief from this requirement, see Regulatory Guide 133 *Managed investments and custodial or depository services: Holding assets* at RG 133.149, ASIC class order [CO 13/1409].
The IOSCO *Objectives and Principles of Securities Regulation* (June 2010) provide that the 'regulatory system should provide for rules governing … the segregation and protection of client assets' (Principle 25).

514 s 601FC(2).

515 The RE may appoint an agent to do anything that it is authorised to do in connection with the scheme: s 601FB(2). ASIC does not consider that the use of custodians is inconsistent with the single responsible entity principle, as responsibility rests solely with the RE under s 601FB(2): ASIC Report 291 *Custodial and depository services in Australia* (July 2012), para 38.
The ALRC/CASAC report noted that, in the light of its proposed reforms, it could be left to scheme operators to decide whether to involve a second party in the running of a scheme (para 3.20). The Explanatory Memorandum to the Bill for the *Managed Investments Act 1998* also recognised that the RE may choose to engage a custodian to hold the scheme property (paras 5.1, 8.5, 8.13).
The original draft Collective Investments Bill, released in 1995, proposed that the legislation require an independent custodian to act as trustee to ensure that the assets of the fund were segregated from the assets of the RE, but without giving the custodian any responsibility for the conduct of the scheme. The *Managed Investments Act 1998* did not include this proposal. See further HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.470.9].
Details about the Australian custodian industry can be found in ASIC Report 291 *Custodial and depository services in Australia* (July 2012), para 1. REs are one of the main users of custodial services in Australia (ASIC Report 291, para 26).

516 para 5.56. See also paras 5.61-5.64 for discussion of the limited role of the custodian.

requirements.[517] Custodians are also seen as providing benefits through independent safekeeping of assets and the use of sophisticated and professional systems.[518]

The Corporations Act specifically exempts custodians of assets of registered schemes (scheme custodians) from the requirement to hold an AFSL.[519] Given this, custodians are not subject to the statutory obligations regarding the holding of client money and property that apply to financial services licensees,[520] in particular that:

- client money be held on trust in a dedicated account for client money[521]
- (subject to the regulations) other client property only be dealt with in accordance with the original terms and conditions on which it was given to the licensee and any subsequent instructions given by the client.[522]

The Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* contains the following rationale for the exemption of scheme custodians from the licensing provisions:

> Custodial and depository services have been included in the new regime to ensure that consumers of these services receive sufficient disclosure to make informed decisions about whether to use the services, and can be confident that service providers are competent, and have adequate compensation arrangements … and provide access to dispute resolution procedure for retail clients. Custodial and depository services have also been included for market integrity reasons, to ensure that service providers have appropriate risk management procedures.
>
> However, there are many circumstances in which client assets are entrusted to third parties where this level of regulation would not be justifiable … where a person merely holds the assets of a managed investment scheme this level of regulation is not justified since the person holding the assets is acting under the direction of the responsible entity of the scheme. The definition therefore only covers situations where a service provider both possesses or controls client assets and provides administrative functions in relation to those assets.[523]

Given that there are no direct licensing controls over scheme custodians, ASIC seeks to exercise a measure of indirect control over those custodians through the licensing requirements for REs. ASIC Regulatory Guide 133 *Managed investments and custodial or depository services: Holding assets* (RG 133),[524] released in November 2013, requires REs that choose to engage another party as the holder of scheme property[525] to impose minimum standards on that party and ensure that the party meets those minimum standards.[526] Those standards require:

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517 RG 166 *Licensing: Financial requirements* (November 2013), paras RG 166.209-RG 166.218 (with Table 9). See also ASIC Report 291 *Custodial and depository services in Australia* (July 2012), para 35.

518 ASIC Report 291 *Custodial and depository services in Australia* (July 2012), para 37.

519 While those who provide a custodial or depository service must be licensed (definitions of 'financial service' and 'financial services business' in s 761A, ss 766A(1)(e), 766E, 911A), 'the holding of the assets of a registered scheme' does not constitute providing a custodial or depository service (s 766E(3)(b)).

520 Part 7.8 Divs 2 and 3.

521 ss 981B, 981H.

522 s 984B.

523 paras 6.110-6.111.

524 This Regulatory Guide followed on from ASIC Report 291 *Custodial and depository services in Australia* (July 2012) and Consultation Paper 197 *Holding scheme property and other assets* (December 2012).

525 An RE must have a written procedure for determining whether it should itself hold scheme property or, if it is to engage another party to hold that property, for determining which other person and on what terms (RG 133.24). Selection of a person to hold property is discussed at RG 133.71-133.74.

526 RG 133.17, RG 133.20, RG 133.59, RG 133.65-RG 133.79.

- an adequate organizational structure (being one that supports separation of assets and segregation of staff to minimise conflicts of interest)[527]
- adequate staffing capabilities[528]
- adequate capacity and resources to perform core administrative activities[529]
- assets being held on trust for the client.[530]

The agreement between the RE and a holder of scheme property must require that property holder to maintain adequate arrangements for reporting breaches of the RE's obligations to ASIC.[531]

Basis on which property is held

A custodian is widely viewed as holding assets as bare trustee on behalf and on the instruction of the RE, though the precise relationship between the custodian and the RE depends on the terms of the relevant custodial agreement.[532]

Also, an RE, in its capacity as an entity that issues a financial product (being interests in the scheme), must hold money from persons applying for interests in the scheme in a separate designated account.[533] The money is taken to be held in trust by the RE for the benefit of the person who paid the money.[534] The relevant provision does not allow for the fact that an RE might use a custodian to hold this application money.

Other legislation

There is limited regulation of scheme custodians in other legislation. For instance, custodians of property of unregistered, but not registered, schemes have obligations to report to AUSTRAC about certain suspicious matters, certain threshold transactions and international funds transfer instructions under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*.[535] Custodians of unregistered schemes may also be required to give compliance reports to AUSTRAC.[536]

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527 RG 133.25, RG 133.31-RG 133.36. There is an exception from the requirement for separation of assets in the case of omnibus accounts (see RG 133.31, Section F of RG 133).

528 RG 133.25, RG 133.37-RG 133.40. For the obligation of an RE to monitor ongoing compliance of the party engaged to hold scheme property, see RG 133.75-RG 133.79.

529 RG 133.25, RG 133.41-RG 133.44.

530 RG 133.25, RG 133.45-RG 133.48.

531 RG 133.100-133.105.

532 RG 133.46, PJC Trio report, paras 7.36-7.44, ASIC Report 291 *Custodial and depository services in Australia* (July 2012), paras 44-47.

533 s 1017E(1), (2).

534 s 1017E(2A).

535 Definitions of 'providing a custodial or depository service', 'reporting entity' and 'threshold transaction' in *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* s 5, s 6 (Item 46 in Table 1), Part 3 Divs 2-4. The definition of 'providing a custodial or depository service' in s 5 refers to, and is in line with, the definitions relating to the provision of custodial or depository services in the Corporations Act and therefore excludes custodians of registered schemes.

536 *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* s 5 (definitions of 'providing a custodial or depository service', 'reporting entity' and 'threshold transaction'), s 6 (Item 46 in Table 1), Part 3 Div 5.

Analysis and discussion

Place of custodians in the regulatory framework

There are two alternative policy approaches for the treatment of custodians in the regulatory framework:

- *Option 1:* maintain the current indirect approach of exempting scheme custodians from the need to hold an AFSL and regulating them indirectly by the use of licensing conditions and requirements imposed on REs
- *Option 2:* require scheme custodians to be licensed.

The rationale for the licensing exemption for scheme custodians (Option 1) was that a scheme custodian acts under the direction of the RE.[537] The implication was that the licensing of the RE would provide an adequate regulatory control over the activities of the custodian.

However, this indirect approach to the regulation of custodians has resulted in a level of regulatory complexity. For instance, as pointed out above, ASIC indirectly imposes financial requirements on scheme custodians by allowing REs to hold a lower amount of net tangible assets if they engage a custodian who satisfies a more substantial NTA requirement.[538]

The indirect approach has also left some regulatory gaps. The RE, as a financial services licensee, has an obligation to report to ASIC breaches that are significant having regard to various factors.[539] However, a breach by a custodian, even though significant for the operations of the custodian, may not constitute a significant breach by the RE, in which case the RE would not report it. Similarly, a breach by a custodian that affects several schemes for which the custodian acts may not be significant for any of those schemes and will therefore not be reported by any of the REs, even though it may be significant from the custodian's point of view.

Requiring custodians of managed investment schemes to be licensed (Option 2) would enable ASIC to identify more readily the organizations that are acting in that role, to carry out its surveillance activities more readily and to impose licence conditions to ensure that custodians provide their services in an appropriate way. These considerations need to be weighed against the additional cost and compliance requirements that scheme custodians would face if they were required to be licensed. However, it should be noted that custodians acting for REs of schemes are already likely to hold an AFSL that permits them to provide custodial and depository services, as their custody clients would typically include clients other than REs of managed investment schemes, such as broker-dealers and superannuation trustees.

Basis on which property is held

It might be appropriate to clarify that a custodian who holds scheme property on behalf of the RE holds it on bare trust for the RE. The RE would hold the beneficial interest on trust

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537 Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 6.111.
538 RG 166 *Licensing: Financial requirements* (November 2013), paras RG 166.209-RG 166.218 (with Table 9).
539 s 912D.

for those members entitled to it under the scheme constitution.[540] This would more clearly reflect existing arrangements.

It may be beneficial for the legislation to make special provision permitting the designated account that is required for application money to be an account of the custodian held on trust for the RE, which would hold the beneficial interest in the application money on trust for the applicant.

Question 7.7.1. Should custodians of scheme property be required to hold an Australian financial services licence?

Question 7.7.2. Are there any reasons why scheme custodians should not be required to be licensed?

Question 7.7.3. Should the Corporations Act be amended to clarify the basis on which custodians of scheme property hold that property on behalf of the RE and, if so, how?

Question 7.7.4. Should the Corporations Act be amended to allow for a custodian to operate a designated account for holding application money?

[540] s 601FC(2).

8 Meetings of scheme members

This chapter discusses the thresholds for members to requisition a scheme meeting, the quorum requirements, the method for electing a chair and the finality of that person's rulings, as well as the voting rules and the adjournment procedures for scheme meetings.

8.1 Requisitioning scheme meetings

The issue

There is uncertainty about how to count the number of members who are entitled to requisition a scheme meeting.

Current position

The RE must call a meeting of scheme members at the request of at least 100 members or members with at least 5% of the votes that may be cast on a resolution.[541] The same test applies for members of a company who want to request a meeting.[542]

Analysis and discussion

There is uncertainty about how the number of members should be counted for the purpose of the 100 member test. For instance:

- where several members hold interests on behalf of the same beneficial owner:
  - is each of those members to be counted separately, or
  - are all such members to be counted together as one member
- conversely, where one member holds an interest on behalf of several beneficial owners:[543]
  - is that member to be counted as one member, or
  - is each of those beneficial owners to be counted separately?

The same questions arise in relation to companies, given that the tests for calling company meetings are the same as those for calling scheme meetings.

By contrast, for the purpose of determining whether a scheme has more than 20 members, and therefore has to be registered, the Corporations Act specifies that:

- joint holders of an interest in the scheme count as a single member, and

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541 s 252B.
542 s 249D.
543 For example, an RE that is the responsible entity of two schemes might hold interests in a third scheme on behalf of each of those schemes in its capacity as RE of each scheme. The register of the third scheme will show the RE as holding the aggregate number of interests of the two schemes.

- an interest held on trust is taken to be held by the beneficiary (rather than the trustee) if the beneficiary is:
  - presently entitled to a share of the trust estate or of the income of the trust estate, or
  - individually or together with other beneficiaries in a position to control the trustee.[544]

The report of the Companies and Securities Advisory Committee (now CAMAC) *Shareholder Participation in the Modern Listed Public Company* (2000) (the CASAC report) recommended that the 100 member test for companies be repealed and that only shareholders who, collectively, hold at least 5% of the votes that may be cast at a general meeting should have the power to requisition a general meeting of a listed public company.[545]

This recommendation is referred to, and the question of repeal of the 100 member test raised again, in CAMAC's discussion paper *The AGM and shareholder engagement*.[546]

CAMAC adopts the principle that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently. A material difference between companies and schemes that may be relevant in deciding whether the regulatory regimes for companies and schemes should differ on this issue is that schemes do not have annual general meetings, while companies do. The 2012 CAMAC report recommended against requiring schemes to hold AGMs[547] in light of its other recommendation to expand the power of scheme members to requisition a meeting. Currently, scheme members can only require the RE to call, or themselves call, a meeting of members to consider special or extraordinary resolutions.[548] CAMAC recommended that the requisitioning power should also be available for scheme meetings to consider ordinary resolutions.[549]

If the 100 member test is retained and clarified, CAMAC's view is that any clarification should be based on the principle that a sufficient number of informed holders representing discrete interests in the scheme should be required for a meeting to be requisitioned.

Question 8.1.1. Should the 100 member test for requisitioning scheme meetings be retained?

Question 8.1.2. If so, should the method for determining who is to be included as a member be clarified:

- by specifying how members who hold interests on behalf of the same beneficial owner are to be counted

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544 s 601ED(4).
545 rec 2.
546 Sections 3.1.6, 3.4.
547 Section 8.2.3. The report also referred to submissions (including that of ASIC) that opposed scheme AGMs, pointing to costs and the fact that scheme members already receive product disclosure, continuous disclosure and periodic statements (Section 8.2.2). The Explanatory Memorandum to the Bill for the *Company Law Review Act 1998* para 10.86 said that the absence of a requirement to hold an annual general meeting for schemes was 'consistent with the usual character of collective investment schemes as passive investment vehicles'.
548 ss 252B-252D.
549 Section 8.2.3.

- by specifying how a member who holds an interest on behalf of several beneficial owners is to be counted
- in some other manner and, if so, how?

8.2 Meeting quorum requirements in scheme constitutions

The issue

The ability of a majority of scheme members to replace the RE is a fundamental principle. However, schemes can adopt provisions in their constitutions that replace the minimal legislative quorum requirements for the holding of scheme meetings with more restrictive requirements that may make it difficult to replace the RE.

Current position

The quorum for a meeting of a registered scheme's members is two members unless the scheme's constitution provides for a different quorum.[550]

The same rule applies to companies[551] under a replaceable rule, which can be displaced or modified by a particular company constitution.[552]

Analysis and discussion

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently. As indicated, the quorum requirements for schemes and companies are already aligned.

However, there may be a need for the quorum requirements for schemes to apply regardless of any contrary provision in a scheme constitution, in contrast with the approach for companies. The RE is the key administrative body involved in the operation of a scheme. It is essential that the RE remain accountable to scheme members for its conduct of the scheme. This accountability is lessened if an RE is entrenched through provisions in the scheme constitution that make it difficult to call a meeting to consider the RE's removal. For instance, the constitution could be amended to stipulate a quorum that represents, say, 25% of the scheme's members by number.

Question 8.2.1. How common is it for scheme constitutions to adopt restrictive quorum requirements?

Question 8.2.2. Should the Corporations Act be amended so that the statutory quorum requirements for scheme meetings cannot be overridden by a scheme constitution:

- in any circumstances or, alternatively
- only where the purpose of a meeting is to consider the replacement of the RE?

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550 s 252R(1), (2). The absence of a quorum will not invalidate a meeting unless the court so orders (s 1322).
551 s 249T.
552 s 135.

8.3 The chair of a scheme meeting

The issue

Should the same rules apply for schemes and companies in relation to:

- the election of a chair by scheme members
- the finality of the chair's decisions
- the voting rights of the chair?

Current position

Manner of election of the chair

Where the chair is to be elected by a resolution by members,[553] the relevant resolution, like other ordinary resolutions, must be decided on a show of hands unless a poll is demanded.[554] However, a registered scheme's constitution may provide that a poll cannot be demanded on any resolution concerning the election of the chair of a meeting.[555] The same rules for the election of the chair of a meeting apply to companies.[556]

Finality of chair's rulings

The chair's decisions are final in relation to:

- determining a challenge to a person's right to vote at the meeting[557]
- making a conclusive declaration of the results of a vote on a show of hands[558] (however, the members present may demand a poll even though the chair's declaration of the voting results for the show of hands is conclusive[559]).

There is no provision for a scheme constitution to provide otherwise. By contrast, the equivalent provisions in relation to companies[560] are replaceable rules.[561]

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553 Members elect a member to be the chair of a meeting:
- where the RE calls the meeting, either of its own motion (s 252A) or at the request of at least 100 members or members with at least 5% of the votes that may be cast (s 252B), but either the RE fails to exercise its right to appoint the chair (s 252S(1)) or the appointed chair is not available or declines to act (s 252S(2)). The RE bears the expense of calling and holding the meeting with a right of indemnity out of scheme assets, not only when it acts of its own motion, but also when it calls the meeting at the request of members (s 252B(9))
- where they have themselves called the meeting, either because the RE has failed to do so at their request, in which case the RE bears the cost of the meeting out of its own funds (s 252C) or because members with at least 5% of the votes that may be cast on a resolution call the meeting, in which case the members themselves pay the expense of calling and holding the meeting (s 252D) (s 252S(3))
- where the court orders the meeting (which it may do 'if it is impracticable to call the meeting in any other way' (s 252E)), unless the court has directed otherwise under s 1319 (s 252S(3)).

554 s 253J(2).

555 s 253K(2)(a).

556 s 250K(2)(a). The provision relating to the manner of election of the chair of company meetings and other rules relating to company meetings have a long pedigree, having been carried over into the replaceable rules from the previous Table A articles of association: Explanatory Memorandum to the Bill for the *Company Law Review Act 1998* para 10.80.

557 s 253G. There is an equivalent provision for chairs of company meetings: s 250G.
A decision on entitlement to vote may be considered final even in the absence of an explicit provision to that effect: *Selim v McGrath* (2003) 47 ACSR 537 at [139], which commented on this question in the context of the powers of a chair of a meeting of creditors of a company in external administration.

558 s 253J(3). There is an equivalent provision for chairs of company meetings: s 250J(2) (a replaceable rule).

559 s 253L(3)(c).

Notwithstanding the statutory provision for finality of a chair's decisions, those decisions will be subject to supervisory review by the courts under the general law if they are made in bad faith or the chair has made an error of law.[562]

Voting rights of the chair

The chair of a meeting of members of a company has a casting vote.[563] If the chair is a member of the company, the chair also has his or her voting rights as a member.[564] These rules apply unless the company's constitution provides otherwise.[565] There is no equivalent provision in relation to schemes.

Analysis and discussion

Manner of election of the chair

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

As indicated, the regimes are already aligned in relation to the potential for a constitution to exclude a poll on any resolution concerning the election of the chair of a meeting.

However, there is an issue whether there are compelling reasons for having different rules for schemes and companies in this area.

Scheme meetings are the mechanism by which the RE of a scheme can be replaced, as well as the forum for members to vote on amendments to the scheme constitution, certain related party transactions and the winding up of the scheme. Although company meetings are the forum for removing directors and appointing new directors, it is more common for individual directors to be replaced, rather than an entire board. By contrast, the RE is the sole governing body for a scheme and its removal and replacement go to the core of control of a scheme and the way it is operated.

Also, the remuneration arrangements for schemes differ from those for companies, with the RE's fees being regulated by the scheme constitution and any increase in those fees requiring approval of an amendment to the constitution by a meeting of scheme members where the increased fees would exceed the maximum permitted under the constitution.[566]

In practice, replacement of the RE and amending the fees payable to the RE have proved to be contentious issues. In these circumstances, the influence that the person chosen to chair a meeting can have on the conduct and, potentially, on the outcome of the meeting[567]

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560 ss 250G, 250J.
561 s 135.
562 *Australian Olives Limited v Livadaras* [2008] FCA 1407 at [70].
563 s 250E(3) (a replaceable rule).
564 ibid.
565 Section 250E is a replaceable rule (see s 135).
566 Changes to a scheme's constitution must be decided by a meeting of the scheme's members where the change would adversely affect members' rights (s 601GC(1)). Members' rights include a right to have the scheme operated and administered according to the scheme constitution as it stands (*360 Capital Re Ltd (ACN 090 939 192) v Watts (as trustees for the Watts Family Superannuation Fund)* [2012] VSCA 234, *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 at [449], [658]-[659], [668]) and the fees that REs can charge are set out in the constitution.
567 *Australian Olives Limited v Livadaras* [2008] FCA 1407 at [67] states the role of the chair of a meeting as follows:

may assume a particular significance for schemes. It may therefore be more important for schemes than for companies that there be no scope for the constitution to exclude the right of scheme members to call for a poll on the election of a chair.[568] Scheme members may be disadvantaged by exclusion of this right if they appoint as their proxy a person who is also the appointee of a large number of other members, as that proxy holder would only have one vote on a show of hands. Unless the members are each able to appoint a different individual to act as proxy, they may feel compelled either to attend the meeting in person or, in effect, to waive their right to influence the election of the chair.

Finality of chair's rulings

In relation to the finality of the chair's decisions in the two identified areas, there are no apparent reasons why the approach for schemes (the constitution cannot alter the position) should differ from the approach for companies (the relevant provision is a replaceable rule, which means that the constitution can make other provision). The relevant Explanatory Memorandum does not give a reason for the different approaches. In fact, in relation to the finality of the chair's decision on a challenge to a person's right to vote,[569] it evinces a general intention that the provision be the same as that for companies in material respects.[570]

Statement of reasons for decision

Members may be assisted in ascertaining whether they have grounds to exercise any rights to challenge decisions of the chair of a meeting by a requirement that chairs of meetings state the reasons for their decisions and include those reasons in the minutes of the meeting.[571]

A requirement of this nature applies to insolvency practitioners when exercising their casting vote in an external administration.[572]

> The duty and function of the chair is to preserve order and take care that the proceedings are conducted in a proper manner and the sense of the meeting is properly ascertained with regard to any question properly before the meeting (*National Dwellings Society v Sykes* [1894] 3 Ch 159 per Chitty J at 162). Upon the chair rests the responsibility for making rulings as to the validity of matters. Some of those matters will be entirely procedural such as decisions concerning the putting of resolutions to the meeting. Others will involve determining an entitlement such as whether a member may vote by proxy having regard to a challenge to the validity of the proxy instrument, compliance with lodgement procedure or by reason of some other deficiency or restriction. The chair may foreshadow a ruling and entertain objections and discussion before deciding the question or invite discussion, then rule and note objections to the ruling.
>
> The Corporations Act stipulates the following powers and functions of the chair of a scheme meeting:
> - to vote proxies according to their terms (s 252Y(4)(c); for chairs of company meetings, see s 250BB(1)(c))
> - to make a final decision on a challenge to a person's right to vote at the meeting (s 253G; for chairs of company meetings, see s 250G) and a conclusive declaration of the results of a vote on a show of hands (s 253J(3); for chairs of company meetings, see s 250J(2))
> - to demand a poll (s 253L(1)(c); for chairs of company meetings, see s 250L(1)(c))
> - to sign the minutes of the meeting within a reasonable time after the meeting (the RE has an obligation to ensure that this is done by the chair of that meeting or by the chair of the next meeting) (s 253M(2); for chairs of company meetings, see s 251A(2)).

568 s 253K(2)(a).

569 s 253G.

570 The Explanatory Memorandum to the Bill for the *Company Law Review Act 1998* para 10.101 refers to various rules for meetings of members of schemes (including s 253G, relating to a challenge to the right to vote) that 'mirror those applying to public companies'.

571 The Court in *Link Agricultural Pty Ltd v Shanahan & Ors* [1998] VSCA 3 had regard to the reasons given to a meeting of shareholders by the chairman in determining the purpose of the chairman's ruling (see at [43]).

572 Corp Reg 5.6.21(4A). This requirement is reflected in the *Code of Professional Practice for Insolvency Practitioners* (third edition, effective 1 January 2014), published by the Australian Restructuring Insolvency & Turnaround Association (ARITA, formerly the Insolvency Practitioners Association), Section 24.7.4.

Voting rights of the chair

There is no apparent reason why the legislation should not provide for the chair of a scheme meeting to have a casting vote and any vote as a member, unless the scheme constitution provided otherwise.

Question 8.3.1. Should it be permissible for a scheme constitution to exclude the right to demand a poll on the election of a chair?

Question 8.3.2. Should it be permissible for a scheme constitution to vary the finality of a chair's decision in relation to:

- determining a challenge to a person's right to vote at the meeting
- making a conclusive declaration of the results of a vote on a show of hands?

Question 8.3.3. Should chairs of meetings be required to state the reasons for some or all of their decisions at the relevant meeting and include those reasons in the minutes? If such a requirement were to apply to some decisions only, to which types of decisions should it apply?

Question 8.3.4. Should the Corporations Act stipulate that the chair of a meeting of scheme members has a casting vote and, in addition, if the chair is a member of the scheme, any vote that the person may have in that capacity?

8.4 Voting restrictions on resolutions at members' meetings

The issue

As a general proposition, the associates of an RE are prohibited from voting on resolutions at scheme meetings if they have an interest in the resolution or matter other than as a member. However, there is a lack of clarity about which definition of 'associate' applies for the purpose of this prohibition. Also, it is unclear why the law permits an RE and its associates to vote on a resolution to replace the RE when the scheme is listed.

Current position

The voting exclusion

The RE of a registered scheme and its associates are not entitled to vote on a resolution at a meeting of the scheme's members if they have an interest in the resolution or matter other than as a member.[573]

Exceptions to the voting exclusion

However, there are two situations in which the voting exclusion does not apply:

- if the scheme is listed, the RE and its associates may vote their interest on resolutions to remove the RE and choose a new RE[574]
- the RE and its associates may vote as proxies for other members provided the instrument of appointment specifies how they are to vote and they vote that way.[575]

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573 s 253E.
574 ibid.

Test of 'associate'

Broadly speaking, the tests of 'associate' are:

- the general test, which covers:
  - 'automatic associateship', where the associates are connected with a body corporate[576]
  - 'associates on the facts', a broad category applicable outside the takeover context and intended to cover persons who are associated in any way[577]
- the takeovers test,[578] applicable in relation to takeovers (Chapters 6 and 6B of the Corporations Act), compulsory acquisitions and buyouts (Chapters 6A and 6B), ownership of companies and schemes (Chapter 6C) and related areas involving voting power or control.[579]

There is some uncertainty about whether the takeovers test or the general test applies to the voting exclusion for associates of REs.[580]

The general test

Under the 'automatic associateship' limb of the general test, the associates of a designated body (which can include a managed investment scheme[581]) are:

- a director or secretary
- a related body corporate
- a director or secretary of a related body corporate.[582]

The 'association on the facts' limb of the general test applies to any entity, whether or not a body corporate, and is based on:

- acting in concert
- actual or proposed formal or informal association, and
- actual or potential transactions, acts or things intended to result in an association.[583]

The takeovers test

Under this test, the associates of a body corporate are:

- another body corporate that the body corporate controls

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575 s 253A(2).
576 s 11. See HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [23.250].
577 s 15. See HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [23.250].
578 s 12.
579 s 12(1).
580 *Australian Olives Limited v Livadaras* [2008] FCA 1407 refers to the takeovers test (see at [4]–[5], [7]). *C & C Fisher Pty Ltd v Livadaras* [2010] FCA 11 at [8] refers to the general test in s 15.
581 s 12(5)(b).
582 s 11.
583 s 15. There is also provision for the regulations to stipulate a test of association: s 15(1)(b). There are no relevant regulations.

- another body corporate that controls the body corporate
- another body corporate that is controlled by an entity that controls the body corporate[584]

while the associates of any person, whether or not a body corporate, are determined on the basis of:

- existing or proposed agreements for the purpose of controlling or influencing the composition of a body's board or the conduct of its affairs[585]
- actual or proposed actions in concert in relation to the body's affairs.[586]

Analysis and discussion

The policy rationale for the restriction on voting by an RE and its associates is to remove the potential for a conflict of interest to arise.[587] However, the current provision raises the following areas of uncertainty:[588]

- *which associates are excluded from voting*: the possible alternatives are:
  - only the *particular members* of the 'associate group' who themselves have an interest, or
  - *all members* of the 'associate group' where any of them has an interest
- *whether an interest as a fiduciary constitutes a disqualifying 'interest':* it is unclear whether interests held by an associate of an RE in a fiduciary capacity exclude the associate from voting and whether the nature of the fiduciary relationship or the nature of the beneficiary affect the decision on this matter
- *who are the 'associates' of the RE:* it is unclear whether this is determined under:
  - the general test of association,[589] or
  - the takeovers test of association,[590] or
  - either the general test or the takeovers test, depending on the nature of the resolution being put to members (with the takeovers test applying if the resolution relates to voting power or control in relation to the scheme and the general test applying in other circumstances).

  This question is relevant in the case of directors and secretaries of the RE (and of related bodies corporate of the RE), who would be associates under the general test,

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584 s 12(2)(a).
585 s 12(2)(b).
586 s 12(2)(c). In relation to the takeovers test, *Australian Olives Limited v Livadaras* [2008] FCA 1407 at [7] said that whether parties were acting in concert was a question of fact and described 'acting in concert' as 'pursuing a common purpose' (see also at [58] for the application of the concept of 'acting in concert' to particular facts).
587 *Southern Wine Corporation Pty Ltd (In Liq) v Perera* [2006] WASCA 275 at [21], *C & C Fisher Pty Ltd v Livadaras* [2010] FCA 11 at [7].
588 These were pointed out in the submission from Freehills (now Herbert Smith Freehills) at Stage 1 of the CAMAC review.
589 ss 11, 13-17.
590 s 12.

and thereby automatically precluded from voting, but not under the takeovers definition.

In CAMAC's view, the takeovers test is the more appropriate criterion for determining who are an RE's associates for the purpose of the prohibition on voting.

A further issue is why REs and their associates are not subject to the voting exclusion when the scheme is listed and the matter for decision is the replacement of the RE. The right to replace the RE is a fundamental right of scheme members, given that they do not have day-to-day control over the operation of the scheme. It is unclear why listing of a scheme obviates the need for the voting exclusion to protect this right from self–interested voting by the RE or its associates.

Question 8.4.1. Should the restriction on the entitlement of an RE and its associates to vote be clarified and, if so, in what respects and in what way? In particular, should it be made clear that the takeovers test applies when determining the meaning of 'associate' for the purpose of this voting exclusion?

Question 8.4.2. Should the current voting exclusion be amended so that it applies regardless of whether the scheme is listed or unlisted?

8.5 Proxy voting

The issue

Should the scheme provisions relating to proxy voting be the same as those that apply to companies?

Current position

The Corporations Act contains rules relating to proxy voting at scheme meetings.[591] For the most part, these are similar to the corresponding provisions for meetings of companies.[592]

However, the following provisions for meetings of companies have no equivalent for schemes:

- the person appointed as the proxy of a member of a company may be an individual or a body corporate[593]
- authentication of proxy appointments for voting at company meetings can be done electronically as well as by signing[594]
- a company can receive proxies through electronic means other than at an electronic address[595] (both companies and schemes can receive proxies at a specified electronic address[596])

591 Part 2G.4 Div 5.
592 Part 2G.2 Div 6.
593 s 249X(1A).
594 s 250A(1A), Corp Reg 2G.2.01.
595 ss 250B, 250BA.

- a proxy who votes must vote in accordance with instructions (the proxy must vote if the proxy is the chair and a proxy with conflicting instructions must abstain on a show of hands)[597]

- the chair must vote if a non-chair proxy does not attend the meeting or does not vote[598]

- a member of the key management personnel or a closely related party (other than a chair who has specific authority to vote) must not vote on a resolution concerning the remuneration of a member of the key management personnel.[599]

Also, the provision governing appointment of proxies for company meetings is a replaceable rule,[600] but the equivalent provision for schemes[601] cannot be varied by a scheme's constitution.

Analysis and discussion

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

There appear to be no reasons for the differences identified above between the proxy voting provisions that apply to schemes and those that apply to companies.

Question 8.5.1. In what respects should the provisions relating to proxy voting for schemes be further aligned with those relating to companies?

8.6 Procedures relating to adjournment of meetings

The issues

The law on adjournment of scheme meetings, as currently interpreted, requires that a new notice of meeting be given for any adjourned meeting that takes place one month or more after the original meeting, even if the gap between two consecutive adjourned scheme meetings is less than one month.

There is no guidance on what information should be included in any new notice.

Adjourned scheme meetings, unlike adjourned company meetings, are prohibited from considering new business.

The members of a scheme, unlike the members of a company, have no power to direct that the chair of a scheme meeting adjourn the meeting.

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596 ss 250B(3)(a)(iii), 250BA(1)(b) (companies), 252Z(3A)(c) (schemes).
597 s 250BB.
598 s 250BC.
599 s 250BD.
600 s 249X
601 s 252V.

Current position

When a meeting of a scheme is adjourned for one month or more, new notice of the adjourned meeting must be given.[602] The equivalent rule for companies contains the same notice requirement,[603] but is a replaceable rule and can therefore be displaced or modified by the company's constitution.[604] The scheme requirement and that applicable to companies both override the common law, under which, in the absence of contrary provision in the relevant rules, it is not necessary to give notice of the adjourned meeting where the date, time and place were fixed at the meeting when it was adjourned.[605]

If notice of a scheme meeting is required, the notice period is at least 21 days unless the scheme's constitution specifies a longer minimum period.[606]

There is only one decision on how the requirement for notice of an adjourned scheme meeting applies where there are multiple adjournments, *Re Colonial First State Trust Group*.[607] The Takeovers Panel in that case suggested that the period of one month, after which notice of the adjourned meeting is required, refers to the period between the original meeting and the relevant adjourned meeting. Fresh notice would be required even if the period between two consecutive adjourned meetings is less than the stipulated one month period. The Panel said:[608]

> The unitholders' Meetings had already been adjourned from 3 September until Monday 30 September. If the meeting was to be adjourned for 1 month or more in total, then section 252K of the Corporations Act (Act) required that new notice must be given to the unitholders. This means that the last possible date for the Meetings to be held under the current notices of meeting was Wednesday 2 October.

The same reasoning would apply where the replaceable rule for companies has not been displaced or modified.

The Corporations Act gives no details about what information a notice of adjourned meeting should contain.

Only unfinished business may be transacted at a scheme meeting resumed after an adjournment.[609] The equivalent rule for companies, which also stipulates that only unfinished business may be transacted at an adjourned meeting,[610] is a replaceable rule and can therefore be displaced or modified by the company's constitution.[611] At common law, new business is permitted to be transacted at an adjourned meeting if notice is given to members.[612]

The chair of a meeting of the members of a company must adjourn the meeting if the members present with a majority of votes at the meeting agree or direct that the chair must do so.[613] There is no equivalent provision for schemes.

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602 s 252K.
603 s 249M.
604 s 135(2).
605 AD Lang, *Horsley's Meetings: Procedure, Law and Practice* (6th edition), Section 4.20.
606 s 252F. Cf ss 249H, 249HA for companies.
607 [2002] ATP 16.
608 at [17].
609 s 252U(2).
610 s 249W.
611 s 135(2).
612 AD Lang, *Horsley's Meetings: Procedure, Law and Practice* (6th edition), Section 13.14.
613 s 249U(4).

Analysis and discussion

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

It is not clear why the Corporations Act does not permit the scheme provisions to override the provisions relating to notice of adjourned meetings and the business that can be considered at those meetings, as is the case with the provisions applicable to companies. At least in relation to the requirement for giving notice, the difference in approach may be a legislative oversight, as the relevant Explanatory Memorandum states that 'the rules on giving notice [for schemes] ... are consistent with those for companies'.[614]

The flexibility to consider new business may assist in conducting scheme business, particularly where the meeting concerns the restructuring of a scheme. Members should, however, receive adequate notice of any new business to be considered at an adjourned meeting.

Also, it is not clear why scheme members should not have the power to direct the chair to adjourn the meeting.

Question 8.6.1. Should a scheme constitution be permitted to vary the current requirement for giving notice of an adjourned scheme meeting?

Question 8.6.2. Should a scheme constitution be permitted to vary the statutory rule prohibiting an adjourned scheme meeting from considering new business?

Question 8.6.3. What details should be given in any notice of an adjourned meeting?

Question 8.6.4. Should the rules relating to adjourned meetings for schemes be aligned with those for companies?

Question 8.6.5. Should the members of a scheme have the power to direct the chair of a meeting of scheme members to adjourn the meeting?

8.7 Other alignment issues

Areas not otherwise identified in this chapter where the provisions governing meetings of scheme members differ from those governing meetings of company members are:

- *time for determining the percentage of votes held by members:* this time is close of business on the day before the poll is demanded in the case of schemes,[615] but the midnight before the poll is demanded in the case of companies[616]
- *timing and manner of poll:* for companies, there is a legislative requirement that, unless the company's constitution provides otherwise:[617]
  - a poll demanded on a matter other than the election of a chair or an adjournment be taken when and in the manner the chair directs

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614 Explanatory Memorandum to the Bill for the *Company Law Review Act 1998* para 10.95.
615 s 253L(4).
616 s 250L(4).
617 The provision is a replaceable rule (s 135).

– a poll on the election of a chair or on the question of an adjournment be taken immediately.[618]

There is no equivalent provision for schemes.

Question 8.7.1. Should the law applicable to scheme meetings be brought into line with that applicable to company meetings in relation to:

- the time for determining the percentage of votes held by members
- the timing and manner of a poll?

[618] s 250M.

9 Other matters relating to scheme members

This chapter discusses the rights of members to have access to the scheme register. It also discusses various means by which members might exit from a scheme and how to identify the point at which a person ceases to be a member.

9.1 Access to scheme registers

The issues

Actions of the RE that prevent members' timely access to the register of members may adversely affect the ability of those members to exercise their rights. The question is what remedies should members have in those circumstances.

A related question is whether persons with a right of access to the register should be entitled to receive access only to the information required by statute to be on the register or whether that right should extend to any additional information that may have been entered on the register.

Current position

Register of members

A registered scheme must set up and maintain a register of members.[619]

The register of members must contain the following information:

- the name and address of each member
- the date on which the entry of each member's name in the register is made
- if the scheme has more than 50 members - an up-to-date and readily usable index of members' names (which need not be separate if the register itself is kept in a form that operates effectively as an index)
- the date on which every issue of interests takes place
- the number of interests in each issue
- the interests held by each member
- the class of interests
- the amount paid, or agreed to be considered as paid, on the interests
- the name and details of each person who stopped being a member of the scheme within the last 7 years and the date on which the person stopped being a member.[620]

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619 s 168(1)(a).
620 s 169(1), (2), (6A), (7).

Register of option holders

A registered scheme must set up and maintain a register of any holders of options over unissued interests and keep with the register copies of documents that grant an option over unissued interests in the scheme.[621]

The register of option holders must contain:

- the names and addresses of option holders and the dates on which their names were entered in the register
- the date of grant of the options
- the number and description of the interests over which the options were granted
- either the period during which the options may be exercised or the time at which the options may be exercised
- any event that must happen before the options can be exercised
- any consideration for the grant of the options
- any consideration for the exercise of the options or the method by which that consideration is to be determined.[622]

Information about the grant of an option must be entered in the register within 14 days after the grant and the register must be updated whenever options are exercised or expire.[623]

Form of registers

The registers may be kept on computer as well as in a bound or looseleaf book.[624]

Access to registers

A registered scheme, through its RE, must allow anyone to inspect the register.[625] If the register is not kept on a computer, the person inspects the register itself.[626] If the register is kept on a computer, the person inspects the register by computer.[627]

Members may inspect the register without charge.[628] Other people may inspect the register on payment of any fee (up to the prescribed amount) required by the scheme.[629]

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621 ss 167A(1)(b), 168(1)(b), 170.
622 s 170(1).
623 s 170(1), (2).
624 s 1306, Note 2 to s 168. A 'book' required by the Corporations Act may be kept 'by recording or storing the matters concerned by means of a mechanical, electronic or other device' (s 1306(1)(b)). 'Book' includes a register (paragraph (a) of the definition of 'books' in s 9).
625 ss 167A(2)(a), 173(1). Other provisions that are relevant to the inspection of registers are ss 1300 (place and times for inspection), 1301 (the location of documents that are kept on computers), 1303 (court power to compel compliance with inspection obligation) and 1306 (form and evidentiary value).
626 s 173(1).
627 ibid.
628 s 173(2).
629 s 173(2), Corp Reg 1.1.01. The prescribed amount is set out in Item 1 of Schedule 4 to the Corporations Regulations.

A registered scheme, through its RE, also has an obligation to give a person a copy of the register (or a part of the register) within 7 days on payment of a fee, provided that the person is not a stockbroker or a sharebroker and does not want the copy of the register for one or more of a number of 'prescribed purposes', including making an unsolicited offer or invitation to purchase interests off-market.[630]

ASIC may allow a longer period to comply with the request.[631] If the register is kept on a computer, the company or registered scheme must give the copy to the person in the prescribed form.[632]

There is also a separate legislative provision obliging the RE not to disclose information on the register if the RE knows that the person receiving the information is likely to use it to contact, or send material to, the scheme member.[633] There is an exception where the intended conduct of the recipient is relevant to the holding of the interests or the exercise of the rights attaching to them.[634] However, this exception does not permit disclosure related to the making of certain unsolicited offers or invitations to purchase interests off-market.[635]

The court has powers to make orders compelling compliance with the obligations to grant inspection, or provide copies, of the register.[636]

Analysis and discussion

Supporting exercise of the right of access

The rights of scheme members to inspect and obtain copies of the register of members can be important in enabling them to exercise their rights of collective action (particularly the right to replace the RE) by consulting with each other. It appears that there have been cases where scheme members who wanted to replace the RE have experienced difficulties in obtaining access to the register of members due to delay or resistance by the RE.[637]

It is important that the right of access to scheme registers be readily exercisable in practice. Under the current law, a failure to comply with the access obligations is an offence of strict liability[638] and the court has the power to make an order compelling compliance.[639] These provisions may be considered adequate protection against delay. Also, persistent refusal by an RE to allow inspection of the scheme's register may be a breach of its licensing obligation 'to ensure that the financial services covered by the

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630 s 173(3), (3A) Corp Reg 2C.1.03. For unsolicited offers or invitations to purchase interests off-market, see s 1019D(1)(a)-(d).
Subsection 173(3A) requires that an application state the purpose for which the person is accessing a copy. The application must also include the name and address of the applicant (Corp Reg 2C.1.04).
For the fee payable to receive a copy of the register, see Item 1AA of Schedule 4 to the Corporations Regulations.

631 s 173(3).

632 Corp Reg 2C.1.02, enacted pursuant to s 173(3), sets out the form in which computer registers are to be provided.

633 s 177. The relationship between ss 173 and 177 was considered in *Direct Share Purchasing Corporation Pty Ltd* v *LM Investment Management Ltd* [2011] FCA 165.

634 s 177(1A).

635 s 177(1AA).

636 s 1303. This section refers to inspection of a 'book'. 'Book' includes a register (paragraph (a) of the definition of 'books' in s 9). The court can also grant an injunction under s 1324.

637 Clarendon Lawyers submission at Stage 1 of the CAMAC review.

638 s 173(9A).

639 s 1303. A member might also seek an injunction under s 1324 for a contravention of s 173, which imposes the obligation to allow inspection of a register.

licence are provided efficiently, honestly and fairly'.[640] Possible disadvantages of having to rely on a court order are the cost of funding a court action (though the court may award costs to a successful applicant member) and the delay involved in having to take such action.

Alternative possible approaches to ensuring access to scheme registers include:

- *Option 1: duty to ensure compliance.* The Corporations Act could impose a duty on the officers of the RE to take the degree of care and diligence that a reasonable person would take to ensure compliance with the provisions for access to registers. As under the current law, a member would face the cost and delay involved in taking action against recalcitrant officers of the RE. However, the potential penalties for breach of the duty might provide an incentive for the officers to ensure compliance

- *Option 2: liability for non-compliance.* The Corporations Act could make the RE and its officers liable for damages for any loss suffered as a result of non-compliance with the provisions requiring access to the scheme's register. As under the current law, a member would face the cost and delay involved in taking action against the RE and/or its officers. However, as with Option 1, the potential liability for non-compliance may provide an incentive to ensure compliance

- *Option 3: obligation to lodge scheme register with ASIC.* The RE could be required to lodge a copy of the scheme's register with ASIC at certain specified periods (for instance, monthly or quarterly). A requirement of this nature would avoid the potential difficulties where an RE refuses access to the register. However, this option may impose an undue administrative burden on ASIC

- *Option 4: a combination of two or more of the above*.

Form of the register

Some registers contain information in addition to that required by the Corporations Act (for instance, the email addresses of scheme members and the name and email address of their financial advisers).[641] It appears that there have been instances where registers have been edited to exclude information that is not statutorily required before access has been granted.

The question is whether, in principle, a member's inspection right should provide access to:

- anything that happens to be recorded on a scheme register, or alternatively

- only the information that the Corporations Act requires to be included on that register.

The latter approach would give REs greater freedom to use the register as a centralised source of information without any concern that the information may become generally available. However, if REs are permitted to remove non-statutory information from registers before making them available, there is a further question whether the Corporations Act should require that the register include additional mandatory items, such

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640 s 912A(1)(a): see P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶55-300. Breach of a licensing obligation can result in cancellation or suspension of the licence (s 915C) or a banning order (Part 7.6 Div 8 Subdiv A).

641 Clarendon Lawyers submission at Stage 1 of the CAMAC review.

as the members' email address and the name and email address of their financial advisers (if the RE knows those details).

Question 9.1.1. Are there legal or practical difficulties in the members of a scheme obtaining access to the scheme register?

Question 9.1.2. If so, should the current requirement for the RE to allow access to the register be supplemented by:

- a duty for the officers of the RE to take the degree of care and diligence that a reasonable person would take to ensure that the RE complies with the access requirement (Option 1)
- liability of the RE and its officers for damages for any loss arising from non-compliance with the access requirement (Option 2)
- a requirement for the RE to lodge a copy of the scheme's register with ASIC regularly and, if so, how often (for instance, monthly or quarterly) (Option 3)
- a combination of two or more of these measures (Option 4)
- some other measure and, if so, what?

Question 9.1.3. Should the right of inspection and the right to obtain copies relate to:

- anything that happens to be recorded on the scheme register, or alternatively
- only the information that the Corporations Act requires to be included on that register?

Question 9.1.4. Should the Corporations Act require any additional information to be included on the register and, if so, what?

9.2 Exit from a scheme

Members may exit from a managed investment scheme by choosing to exercise their rights under any withdrawal procedures, as discussed in Section 9.3. Members of a listed scheme, or an unlisted scheme admitted to the AQUA market operated by the ASX,[642] can exit from the scheme by selling their interests in the scheme on-market, rather than pursuant to a withdrawal procedure in the scheme's constitution.[643]

Members might also exit from a scheme if they accept a buy-back offer from the RE. There is currently no statutory buy-back procedure for schemes, though the ASX listing rules and ASIC relief have facilitated on-market buy-backs for listed schemes. The

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642 The AQUA market was created by the ASX for the quotation and trading of interests in unlisted managed funds (as well as exchange traded funds (ETFs) and structured products): ASIC Regulatory Guide 198 *Unlisted disclosing entities: Continuous disclosure obligations* at 17, ASIC Consultation Paper 196 *Periodic statements for quoted and listed managed investment products and relief for AQUA products* (December 2012) para 4. See also ASIC Report 282 *Regulation of exchange traded funds*.
To gain admission to Trading Status on the AQUA market, a scheme must be 'an open ended scheme, being a scheme which continuously issues and redeems Financial Products based on the net asset value of the Managed Fund' (ASX Operating Rules Schedule 10A clause 10A.3.4(a)) and must be liquid (ASX Operating Rules Schedule 10A clause 10A.3.6). Schemes that cannot be admitted to the AQUA market include property trusts and infrastructure funds, as they are non-liquid schemes for the purposes of Part 5C.6 of the Corporations Act because of the nature of the assets they hold (ASX Operating Rules Schedule 10A clause 10A.3.3(d)(ii), (iii), ASIC Regulatory Guide 134 *Managed investments: Constitutions* at RG 134.51).
Members of schemes admitted to the AQUA market may exit by using the withdrawal procedures for liquid schemes, as discussed in Section 9.3. Participants in the AQUA market are generally wholesale participants.

643 ASX Listing Rule 1.1 Condition 5.

possible development of a statutory buy-back procedure for schemes is discussed in Section 9.4.

Scheme members may also withdraw from a scheme under a scheme reorganization. Scheme reorganizations are discussed in Section 11.2 of this paper.[644]

The identification of the point at which a person who is exiting from a scheme ceases to be a scheme member is discussed in Section 9.5.

9.3 Scheme liquidity and the procedure for withdrawal

The issues

The definition of liquid assets[645] may adversely affect investors by enabling the RE of a scheme to market the scheme as liquid, notwithstanding the potential for a significant proportion of the assets not to be readily realisable within the period that investors may expect to be able to withdraw.

Are there any procedural difficulties that impede the operation of the withdrawal provisions of the Corporations Act?

Current position

It is not necessary for the members of a scheme to have a right to withdraw from the scheme,[646] but, if they are to have such a right, it must be set out in the scheme's constitution and the requirements in the constitution must be satisfied.[647] The right to withdraw, and any provisions in the constitution setting out procedures for making and dealing with withdrawal requests, must be fair to all members.[648] ASIC has provided guidance on aspects of the withdrawal procedure that should be covered in a scheme's constitution (as discussed below).

If a scheme is non-liquid, there are statutory procedures (discussed below) that must be satisfied for withdrawal from the scheme in addition to any procedures specific to the scheme.[649] These statutory procedures must also be reflected in the scheme's constitution.[650]

The withdrawal procedures are based on recommendations in the ALRC/CASAC report.[651] Those procedures replaced the requirement, applicable to unlisted schemes operating under the prescribed interest provisions that preceded Chapter 5C,[652] for a

644 An additional means for investors to exit from a scheme would be to terminate the scheme and liquidate its assets. This mechanism would only be used in extraordinary circumstances: see ALRC/CASAC report vol 1, para 7.2.
645 s 601KA(5), (6).
646 Regulatory Guide 134 *Managed investments: Constitutions* at RG 134.148.
647 ss 601GA(4)(a), 601KA(1)-(3). In ASIC's view, provisions that allow a member to cease to be a member on request can confer a 'right to withdraw': if the RE has a discretion about whether to act on the request, the member's right would generally arise on the exercise of the discretion to allow withdrawal or at a later point before the withdrawal is effected (RG 134.150). The right need not be an automatic or unconditional right (RG 134.151).
648 s 601GA(4).
649 ss 601KA(3), 601KB-KE.
650 s 601KA(2).
651 paras 7.15-7.21.
652 Former Part 7.12 Div 5.

covenant by the manager to make and maintain adequate buy-back arrangements,[653] so that investors could realise their investment by selling it back via the manager.[654]

Withdrawal from a liquid scheme

If members are to have a withdrawal right while the scheme is liquid,[655] the constitution must specify that right and set out adequate procedures for making and dealing with withdrawal requests.[656]

A registered scheme is liquid if liquid assets account for at least 80% of the value of scheme property.[657] The following are liquid assets unless it is proved that the RE cannot reasonably expect to realise them within the period specified in the constitution:

- money in an account or on deposit with a bank
- bank accepted bills
- marketable securities.[658]

Any other property is a liquid asset if the RE reasonably expects that the property can be realised for its market value within the period specified in the constitution for satisfying withdrawal requests while the scheme is liquid (the reasonable expectation test).[659]

Withdrawal from a non-liquid scheme

If a withdrawal right is to be exercisable while the scheme is not liquid:

- the constitution must:
  - provide for the right to be exercised in accordance with the relevant Corporations Act requirements (Part 5C.6)
  - set out any other adequate procedures for making and dealing with withdrawal requests
- the constitutional and statutory requirements must be satisfied.[660]

The statutory requirements are:

- the RE may offer members an opportunity to withdraw, wholly or partly, from the scheme to the extent that particular assets are available and able to be converted to

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653 Corporations Law s 1069(1)(d).

654 Under this requirement, the manager had to buy, or find a buyer for, a unitholder's units at a price determined in accordance with the deed, though ASIC granted many exemptions: HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.485.12].

655 The meaning of a 'liquid scheme' (which in turn depends on the meaning of 'liquid assets') is explained in s 601KA(4)-(6). Similarly, liquidity criteria are used in identifying those schemes for which shorter Product Disclosure Statements can be used: see the definition of 'simple managed investment scheme' in Corp Reg 1.0.02.

656 s 601GA(4)(b).

657 s 601KA(4).

658 s 601KA(5). The term 'marketable securities' is defined in s 9.
Property of a prescribed kind may also satisfy the definition of 'liquid assets' (s 601KA(5)(d)). However, there are no relevant regulations.

659 s 601KA(6). HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.507] states that 'it is important that the constitution should not specify too short a time for satisfying withdrawal requests, and that a proper assessment of liquidity be made and maintained'.

660 ss 601GA(4)(c), 601KA(2), (3)(b).

money in time to satisfy withdrawal requests that members may make in response to the offer.[661] Though the RE decides when members should have a withdrawal opportunity, the initiative to withdraw comes from the members themselves

- a withdrawal offer must be in writing and must be made in accordance with any procedures in the scheme's constitution or, if there are no such procedures, by giving a copy of the offer to all members of the scheme (or to all members of a particular class)[662]
- the offer must specify:
  - the period during which it will remain open (at least 21 days)
  - the assets that will be used to satisfy withdrawal requests
  - the amount expected to be available when those assets are converted to money
  - the method for dealing with withdrawal requests if the money available is insufficient to satisfy all requests. That method must comply with the statutory procedure for making payments in satisfaction of withdrawal requests[663]
- the RE must ensure compliance with that statutory procedure, under which:
  - withdrawal requests must be satisfied within 21 days after the offer closes
  - no request should be satisfied while the offer is still open
  - the requests must be satisfied proportionately if an insufficient amount of money is available from the assets specified in the offer to satisfy all requests[664]
- only one withdrawal offer may be open at any time in relation to a particular interest.[665]

The RE may cancel a withdrawal offer in relation to a non-liquid scheme before it closes if it contains a material error and must cancel the offer if it is in the best interests of members to do so.[666]

A withdrawal offer may relate to a particular class of interests in the scheme only. In that case, the above procedures would apply to withdrawal from that class.

ASIC guidance

ASIC Regulatory Guide 134 *Managed investments: Constitutions* provides the following guidance on the nature and content of any withdrawal procedures in a scheme's constitution:

- what constitute 'adequate procedures' for making and dealing with withdrawal requests will depend on the circumstances of the scheme[667]

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661 s 601KB(1).
662 s 601KB(2).
663 s 601KB(3).
664 s 601KD. This pro rata sharing requirement was part of the withdrawal procedure recommended in ALRC/CASAC report and designed to ensure that investors are treated equally (para 7.21).
665 s 601KC.
666 s 601KE.

- the constitution need not set out every aspect of the withdrawal procedures, but should set out key rights, so that members can determine their right to withdraw and be protected against adverse changes other than by special resolution[668]

- the constitution should provide sufficient information to enable the determination of how a member may trigger the right to withdraw and what (if any) preconditions apply (for instance, that the interests have been held for a minimum time)[669]

- the constitution should contain provisions about:

  – the price that will apply to the interests that are the subject of a withdrawal request

  – when the amount is to be paid to members and the maximum period for payment after withdrawal

  – the nature of the amount that members will receive and how non-monetary assets will be valued[670]

- the constitution should describe any circumstances in which a member's right to withdraw is restricted and set out any discretion that the RE has to restrict withdrawal[671]

- the constitution should only permit members' interests to be redeemed in accordance with the procedures for liquid schemes if the scheme is liquid when the scheme property is valued for the purposes of calculating the withdrawal price. If a scheme becomes non-liquid after a member's request to withdraw but before the property is valued for the purpose of determining the withdrawal price, the withdrawal procedure for non-liquid schemes should be followed[672]

- the constitution must not allow a member to exercise a right to withdraw from a non-liquid scheme other than in response to a current withdrawal offer[673]

- the provisions that affect the price that members will receive on withdrawal, and the procedures for satisfying withdrawal requests, must be fair to all members[674]

- withdrawal prices, including where the consideration is to be paid *in specie*, should be based on valuations that are consistent with the range of ordinary commercial practice

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667 RG 134.153.

668 RG 134.154-RG 134.155.

669 RG 134.158. A provision that allows the RE to determine any pre-conditions from time to time or at its own discretion would not satisfy this criterion (RG 134.159).

670 RG 134.160, RG 134.170.

671 RG 134.162. Examples of restrictions that should be described in the constitution include:
- circumstances in which an RE may suspend and resume withdrawals
- any right to impose minimum and maximum limits on the number or value of interests that may be withdrawn by a member
- the ability to satisfy requests on a partial or staggered basis (RG 134.163).

ASIC expects that any discretion would be exercised consistently with the RE's duties under s 601FC and that, generally, any suspension that is material in duration would be disclosed to members under s 675 if the scheme is a disclosing entity (RG 134.164).

672 RG 134.172.

673 RG 134.173. For instance, a scheme constitution should not allow a member to make a withdrawal request 'from time to time' rather than in response to an offer by the RE.

674 RG 134.174. This requirement follows from the statutory requirement that the right to withdraw, and any procedural provisions in the constitution for making and dealing with withdrawal requests, must be fair to all members (s 601GA(4)).

for valuing assets of that type and be reasonably current, as the valuations affect the amount to which a member is entitled on withdrawal and the value of the remaining assets[675]

- withdrawal offers should be made in such a way as to ensure that all members to whom the offer is made have access to a copy of the offer[676]

- if the constitution includes a discretion for the RE to suspend a right to withdraw, it should set out the circumstances in which the RE can exercise that discretion.[677]

Analysis and discussion

Definition of liquid assets

The reasonable expectation test in the definition of liquid assets has resulted in investors being unable to withdraw their funds when property classified as liquid under that test later proved not to be as readily realisable as had originally been expected by REs and investors in schemes. This occurred, for instance, during the global financial crisis in relation to pooled mortgage funds and direct property funds.

The reasonable expectation test for determining whether property is a liquid asset:

- is imprecise

- is difficult to verify independently (particularly for investors who do not have access to all the information available to REs), as it relies on the RE's own assessment, which may in some instances be affected by conflicts of interest

- permits instability by enabling a managed fund to be classified as liquid or non-liquid depending on whether the RE reasonably expects that the asset can be realised in the timeframe specified in the scheme's constitution. There is no limit on the realisation period the RE can set in the constitution.

Investors' ability to withdraw from a managed fund marketed as liquid may be adversely affected by the RE's honest but mistaken belief that a class of asset can be realised in a specified time period, even where that belief was formed on reasonable grounds.

It may be useful to introduce a clearer or more objective test of liquidity. For instance, the definition of 'liquid assets' could refer to items such as:

- money in an account or money on deposit with a bank, available for withdrawal immediately or on maturity of a fixed term not exceeding three months during normal bank business hours, or

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675 RG 134.175-RG 134.176, RG 134.178. RG 134 also states that, where consideration may be paid *in specie* or in more than one form, the RE should consider the rights and interests of all members when deciding:
- the nature of the consideration
- who bears liability for any transaction costs associated with the transfer of assets, and
- whether the consent of the withdrawing member is required

given the RE's duties to act in the best interests of members (s 601FC(1)(c)) and to treat members of the same class equally and of different classes fairly (s 601FC(1)(d)) and its fiduciary relationship with members (at RG 134.161; see also RG 134.179).

676 RG 134.177. This paragraph of RG 134 advises REs to consider whether an offer made only via the Internet or another form of public communication (such as a newspaper) would be 'fair' and consistent with the RE's duties under s 601FC(1)(d).

677 RG 134.180. There could be a limited range of circumstances or the RE might have the discretion to suspend whenever it thinks fit (RG 134.181).

- a bank accepted bill with a maturity date not exceeding three months, or
- an asset that can reasonably be expected to be realised for its book value within 7 business days.[678] The brevity of this timeframe may reduce the risk that the RE's reasonable expectations may not be realised and the risk that a scheme will change character from being a liquid scheme to a non-liquid scheme.

A more stringent test would reduce the risk that members' expectations about withdrawal timeframes will not be satisfied. However, it would increase the likelihood of REs having to rely on withdrawal procedures for non-liquid schemes, which can be restrictive and costly.

Procedures for withdrawal

REs currently have limited means to manage the capital of the schemes that they operate. Consideration might be given to whether the statutory withdrawal procedure might be made more flexible, particularly in relation to the requirement for proportionate sharing where available funds are not sufficient to meet all withdrawal requests from members in response to an offer by the RE. Section 9.4 considers the possibility of enhancing the ability of REs to manage capital by providing a statutory buy-back procedure for schemes.

Another possible change that may provide for more effective regulatory supervision and greater investor protection may be to provide ASIC with a power to stop a withdrawal offer from proceeding.

Question 9.3.1. Is the definition of liquid assets appropriate? If not, how should liquid assets be defined?

Question 9.3.2. Should the requirement for pro rata sharing of available funds in relation to withdrawal from a non-liquid scheme be modified and, if so, how and why?

Question 9.3.3. Should the procedure for withdrawal from a scheme be modified in any other way and, if so, how and why?

Question 9.3.4. Should ASIC be given any administrative powers in relation to withdrawal, for instance a power to stop a withdrawal offer?

9.4 Possible buy-back procedure for scheme interests

The issue

Should a statutory buy-back procedure similar to that available for companies be available in relation to managed investment schemes?

Current position

There is a prohibition on making unsolicited offers to purchase scheme interests off-market.[679] This prohibition prevents schemes from implementing an off-market buy-back procedure. The prohibition does not affect members' withdrawal rights under the scheme provisions (discussed in Section 9.3),[680] as those provisions do not involve the RE

[678] cf the tests in the definition of 'simple managed investment scheme' in Corp Reg 1.0.02.
[679] Part 7.9 Div 5A.
[680] Part 5C.6.

making an offer to purchase members' interests, but rather provide an opportunity for members to withdraw.

Although the Corporations Act does not contain any specific prohibition that prevents on-market buy-backs by REs of registered schemes, it presents various practical impediments:[681]

- any right of members to withdraw from a scheme must be specified in the scheme's constitution, which must also set out adequate procedures for withdrawal in a way that is fair to all members.[682] However, a right to withdraw in an on-market buy-back arises under a market contract, rather than being specified in the scheme's constitution[683]

- if a scheme is non-liquid, a scheme constitution must provide for the right of withdrawal to be exercised in accordance with the statutory provisions for withdrawal from non-liquid schemes (Part 5C.6).[684] A payment to members by an RE out of scheme property may be a withdrawal, and many ASX-listed schemes (such as property trusts and infrastructure funds) may be classified as non-liquid, for the purposes of Part 5C.6.[685] However, the statutory provisions for withdrawal include a requirement that withdrawal requests are to be satisfied proportionately if there is insufficient money to satisfy them in full.[686] This requirement cannot operate consistently with the ASX Operating Rules, which require that offers to sell be filled on the basis of price and time priority,[687] rather than proportionately[688]

- a buy-back could increase the voting power of a person in scheme interests beyond the limit that is permissible without a takeover offer.[689]

Nevertheless, the ASX Listing Rules contemplate on-market buy-backs of interests in listed schemes. Those rules require a listed scheme to consult the ASX before embarking on any on-market buy-back and to comply with any requirements that the ASX sets, for instance, a requirement to comply with:

- the Corporations Act as if it were a company, or

- the listing rules relating to on-market buy-backs by companies

with any appropriate adaptations.[690]

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681 See the Explanatory Statement to ASIC Class Order [CO 07/422] and ASIC Regulatory Guide 101 *On-market buy-backs by ASX-listed schemes* (RG 101) at RG 101.2, RG 101.7.
682 s 601GA(4).
683 RG 101.9.
684 s 601GA(4)(c).
685 RG 101.12-RG 101.13.
686 s 601KD.
687 ASX Operating Rule [4030]. See also RG 101.29.
688 RG 101.14.
689 s 606. See RG 101.17. There is an exception from the takeover provisions for acquisitions that result from a company buy-back (s 611 Item 19).
690 ASX Listing Rule 7.36.

ASIC has given relief to permit on-market buy-backs by ASX-listed schemes that have no more than one class of interest[691] on the following conditions:

- the scheme's constitution confers this power on the RE[692]
- the buy-back does not materially prejudice the RE's ability to pay scheme creditors[693]
- the buy-back is carried out in the ordinary course of trading on the financial market of the ASX[694] and the purchase price is paid from scheme property
- the RE complies with the Listing Rules in relation to the buy-back as if the scheme were a listed company (including the requirement that the buy-back price not be more than 5% above the average of the market price for interests in the scheme[695])[696]
- the RE immediately cancels the interests bought back[697]
- the buy-back receives the approval of scheme members if it exceeds the 10/12 limit (being 10% of the smallest number, at any time during the previous 12 months, of interests in the scheme)[698]
- the buy-back is disclosed to the ASX if it is within the 10/12 limit[699]
- any discretions in relation to the setting of the buy-back price must be exercised reasonably and the exercise of any discretion must be documented.[700]

The ASIC relief makes it clear that the provisions relating to scheme constitutions, withdrawal from non-liquid schemes and takeovers discussed above do not apply to a buy-back that satisfies the stipulated conditions.

ASIC has also been prepared to grant relief to facilitate an off-market scheme buy-back where the scheme was part of a stapled structure, in which investors hold shares in a company (which usually takes the active role of operating the enterprise) and interests in a scheme (through which the property of the enterprise is held) and the company shares and scheme interests can only be purchased and sold together.[701]

Analysis and discussion

The provision of a statutory buy-back procedure for schemes along the lines of that available for companies would be consistent with CAMAC's general approach that the

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691 ASIC Class Order [CO 07/422]. See also the Explanatory Statement to the class order and ASIC Regulatory Guide 101 *On-market buy-backs by ASX-listed schemes* (RG 101). The class order applies only to schemes that have no more than one class of interests due to the 'risk that on-market buy-backs by schemes with more than one class of interests might dilute the value of holdings of members of another class and might not be fair to all members': see RG 101.4, RG 101.21-RG 101.22.

692 RG 101.25-RG 101.26.

693 RG 101.27.

694 RG 101.28-RG 101.30.

695 ASX Listing Rule 7.33.

696 RG 101.31-RG 101.34.

697 RG 101.35-RG 101.36.

698 RG 101.37-RG 101.49.

699 RG 101.50-RG 101.57.

700 RG 101.58-RG 101.60.

701 ASIC Gazette No. ASIC 22/09, Notice 09-00173 in relation to the Macquarie Media Group. The relief in relation to the scheme component of the stapled structure was given pursuant to s 601QA.

regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.[702]

The ALRC/CASAC report recommended specific procedures for the buy-back of scheme interests.[703] The procedures it recommended were in many respects the same as those that it recommended for the redemption of scheme interests[704] and that have now become the withdrawal provisions in Part 5C.6 (discussed in Section 9.3 of this paper). The report did not consider the option of adopting buy-back provisions for schemes modelled on those for companies.

A statutory buy-back procedure for schemes may enhance the ability of REs to manage scheme capital by providing a capital management mechanism that is more flexible than the current statutory withdrawal procedure. The withdrawal procedure protects the interests of investors by enshrining an equal opportunity principle whereby all members wanting to withdraw have the opportunity to do so and the funds available to pay them are shared among them proportionately if there are insufficient funds to pay them in full.[705] By contrast, a statutory buy-back procedure could give REs a range of capital management options that provide alternative investor protection safeguards. The corporate buy-back procedure,[706] on which the schemes procedure could be modelled, provides for:

- an equal access scheme buy-back[707]
- a minimum holding buy-back (applicable to listed companies)[708]
- an on-market buy-back[709]
- an employee share scheme buy-back[710]
- a selective buy-back.[711]

The policy underlying the equal access scheme buy-back for companies reflects that underlying the managed investment scheme withdrawal provisions, namely providing investors with an equal opportunity to share in benefits. An equal access scheme buy-back for a company requires no shareholder approval if it is within the 10/12 limit[712] (being

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702 Similarly, ASIC has observed that the relief granted in its Class Order [CO 07/422] was intended to 'avoid placing listed schemes at a regulatory disadvantage to listed companies in relation to capital management techniques where there is no regulatory reason for different treatment of listed schemes and listed companies' (RG 101.5).

703 para 7.12.

704 para 7.21.

705 A withdrawal offer can also be made to specific classes of members. In this respect, the RE is under a duty to treat members who hold interests of different classes fairly (s 601FC(1)(d)).

706 The regime governing company buy-backs is in Part 2J Div 2. ASIC Regulatory Guide 110 *Share buy-backs* (RG110) provides guidance for companies on compliance with the share buy-back provisions, including when ASIC may grant relief from those provisions.

707 Under this type of buy-back, offers are made to buy back the same percentage of shares from every person who holds ordinary shares (definition of 'equal access scheme' in s 9, s 257B(2), (3)).

708 This is a buy-back of all of a holder's shares in a listed corporation if the shares are less than a marketable parcel (definition of 'minimum holding buy-back' in s 9).

709 This is a buy-back by a listed corporation on a prescribed financial market in the ordinary course of trading on that market (definition of 'on-market buy-back' in s 9).

710 This involves a scheme whose purpose is the acquisition of shares by or on behalf of employees or salaried directors of the company or a related body corporate and that has been approved by the company in general meeting (definition of 'employee share scheme buy-back' in s 9).

711 This is any buy-back that is not an equal access buy-back or one of the other specific types of buy-back (definition of 'selective buy-back' in s 9).

712 s 257B(1).

10% of the smallest number, at any time during the previous 12 months, of votes attaching to the voting shares in the company[713]). A requirement for shareholder approval by ordinary resolution of shareholders applies to equal access scheme buy-backs that exceed the 10/12 limit,[714] as well as on-market buy-backs and employee share scheme buy-backs.[715]

A different investor protection mechanism applies to selective buy-backs of company shares, which require approval by:

- a special resolution passed at a general meeting of the company, with no votes being cast in favour of the resolution by any person whose shares are proposed to be bought back or by their associates, or
- a resolution agreed to unanimously by all ordinary shareholders at a general meeting.[716]

This range of buy-back options, which could be available to REs if buy-back provisions for schemes were introduced, would give REs a wider range of capital management techniques than the current withdrawal mechanism, which requires an RE to make the same offer to all members and satisfy their withdrawal requests proportionately if there are insufficient funds to satisfy demand.

A statutory buy-back procedure for schemes would also allow for greater uniformity of approach to corporate and scheme buy-backs, which would be particularly useful where the buy-back involves a stapled enterprise structure. For some types of corporate buy-back (including an on-market buy-back over the 10/12 limit), a company buy-back involves the lodgement with ASIC of notices of meeting and other documents relating to the buy-back.[717] By contrast, the ASIC relief facilitating on-market buy-backs of scheme interests does not require lodgement of documents with ASIC. After the completion of an on-market buy-back for a stapled enterprise structure, the relevant ASIC form for the cancellation of company shares following a buy-back[718] is attached to the company's announcement to the ASX. However, that announcement does not give a balanced or comprehensive view of the buy-back, as it does not include information about the change to the scheme interests.

A buy-back of scheme interests might be used as part of a broader reorganization of a scheme's affairs. Scheme reorganizations are discussed in Section 11.2 of this paper.

Question 9.4.1. Should there be a buy-back procedure for interests in managed investment schemes?

Question 9.4.2. If so, should it be based on that provided for companies or take some other form?

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713 s 257B(4).
714 s 257C.
715 s 257B(1). In relation to on-market buy-backs, ASIC considers that:
> buying back interests in the ordinary course of trading on ASX is a fair procedure because trades on ASX's trading system operate according to price–time priority. This results in the better-priced orders taking priority and if there is more than one order at the same price, the order that was placed first takes priority (RG 101.29).

716 s 257D.
717 ss 257C(3), 257D(3), 257E, 257F(2).
718 Form 484 (see Section C1 Cancellation of shares).

Question 9.4.3. How should any buy-back procedure for schemes relate to the withdrawal procedure for schemes (either as currently set out in Part 5C.6 or as amended (see Questions 9.3.1-9.3.4))?

9.5 Ceasing to be a scheme member

The issue

It may be difficult to determine when a person ceases to hold an interest in a scheme and hence ceases to be a member.

Current position

Section 9 defines a 'member' in relation to a managed investment scheme as 'a person who holds an interest in the scheme'.[719] Consequently, a person ceases to be a member when the person ceases to hold an interest in the scheme. As discussed in Section 3.2 of this paper, the definitions of 'interest' and 'member' are very broad and lack clarity: in contrast with companies,[720] 'whether a person is a member of a scheme does not depend on whether the person appears in the register of members'.[721]

Analysis and discussion

Some guidance on when a person ceases to be a member of a scheme is found in *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd*,[722] where the Court said:[723]

> As with the issue of units, the redemption of units in a registered scheme is an event that does not occur automatically, absent some special provision in the constitution of the scheme ... . Redemption occurs when a unitholder's redemption request is accepted by the responsible entity, or a person with the authority of the responsible entity, and the unitholder's holding in the unit register is adjusted to cancel the redeemed units … Once redemption has taken place, the position of the former unitholder is 'transmuted' from unitholder to creditor, if the redemption price is unpaid.

Under this judicial test, therefore:

- a member ceases to be a member once redemption has taken place (and, if paid, will have no further interest in the scheme or, if unpaid, will be a creditor of the scheme)
- redemption, in turn, occurs once the following two steps have both been completed:
  - the member's redemption request is accepted by the RE (or a person with the authority of the RE), and
  - the member's holding in the unit register is adjusted to cancel the redeemed units.

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719 The definition of 'member' of a scheme is discussed in Section 3.2 of this paper.
720 s 231.
721 P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶65-200.
722 [2008] NSWSC 766.
723 at [142].

Despite this guidance from the case law, there may still be doubt about precisely when the first of these steps in the redemption process (acceptance of the redemption request by the RE) has been completed.

There would also be a particular problem if the value of a person's interest had not been calculated when the person ceased to be a member.

This issue may be important where a person has not received payment after withdrawal from a scheme. If the person is no longer a scheme member, the person would not have access to the range of remedies available to members in a dispute with the RE.[724]

One option is for the Corporations Act to clarify at what point between the time when an RE decides to act on a withdrawal request and the time of payout the member ceases to have an interest.

An alternative option would be for the Corporations Act to stipulate that a person continues to be a member until the person has been paid or provided with any amount due on withdrawal from the scheme.

This issue would be resolved if the Corporations Act were amended to provide that a person is only a member of a scheme if the person is on the register of members (see the discussion in Section 3.2 of this paper): the person would cease to be a member when he or she was removed from the register. A change to this effect would align the law for schemes with that for companies, in accordance with CAMAC's general approach that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

Question 9.5.1. Should the Corporations Act clarify when a withdrawing member ceases to be a member of a scheme and, if so, how?

[724] For instance, s 601MA. On the other hand, in some circumstances there can be advantages in a person no longer being a member. For instance, in *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd* [2008] NSWSC 766, it was pointed out (at [162]) that a former member can assert a right as creditor to payment of a redemption price even if payment of the redemption price has been deferred under the provisions of the scheme's constitution.

10 Disclosure

This chapter considers whether the current disclosure requirements provide the most appropriate disclosure framework for interests in managed investment schemes. It also raises for consideration whether there is a need for any additional specific disclosures and examines possible means of making required disclosures.

10.1 Overview of the chapter

Disclosure requirements play an important part in the investor protection framework. Section 10.2 discusses the role that disclosure plays in the conduct of managed investment schemes.

Section 10.3 identifies the three broad types of disclosure to scheme investors.

Section 10.4 looks at the initial disclosure regimes for securities and scheme interests, including how those regimes have diverged. It examines the policy considerations underlying the changes to the respective regimes and raises for consideration whether initial disclosure for schemes should be more closely aligned with that for companies and whether there is a need for any additional specific types of disclosure.

Section 10.5 deals with continuous disclosure and significant event reporting, while Section 10.6 deals with periodic disclosure.

Section 10.7 evaluates the appropriateness of alternative vehicles for initial disclosure, as well as the best way of disseminating any type of disclosed material.

10.2 Role of disclosure

The ALRC/CASAC report accepted that mandatory disclosure rules for managed investment schemes are essential on efficiency and equity grounds.[725] It saw mandatory disclosure as having an important role for commercial enterprises that are characterized by a separation of ownership and control (including schemes). Mandatory disclosure for schemes can:

- increase the accountability of scheme operators to investors by reducing the information gap between those parties
- alert existing and potential investors to significant developments in the performance of the scheme and, possibly, to inefficiency or misconduct on the part of the RE
- help individuals decide whether investment in a particular scheme is advantageous in light of the rest of their personal asset holdings

[725] para 5.3.

- reduce significantly the costs associated with schemes, including by:
  - providing common disclosure rules (thereby obviating the need to develop rules for each scheme, the cost of which would flow on to investors), and
  - reducing the duplication of search and research costs by investors and the uncertainty in assessing the risks and benefits of different schemes
- reduce the information gap between different classes of investors
- increase the accuracy of prices of scheme interests and thereby improve the efficiency with which the capital market allocates financial resources among competing investment opportunities.[726]

10.3 Types of disclosure

Investors in managed investment schemes receive:

- initial disclosure (or fundraising disclosure), which applies to initial issues of financial products to an investor[727] as well as to a limited range of secondary sales[728] (discussed in Section 10.4)
- continuous disclosure, which is primarily aimed at ensuring an informed secondary market for financial products that are subject to the continuous disclosure regime[729] (discussed in Section 10.5) (significant event reporting plays the same role in relation to financial products that are not subject to continuous disclosure: this type of reporting is also discussed in Section 10.5)
- periodic disclosure (discussed in Section 10.6).

10.4 Initial disclosure

10.4.1 Historical overview

Before the introduction of the managed investment scheme provisions in Chapter 5C, managed investment schemes were regulated as 'prescribed interests',[730] which came within the definition of 'securities'.[731] The disclosure document for prescribed interests was a prospectus. The discussion of disclosure in the ALRC/CASAC report was premised on the disclosure document for scheme interests being a prospectus.[732]

When the managed investment provisions in Chapter 5C were introduced into the Corporations Act by the *Managed Investments Act 1998*, interests in managed investment schemes (like prescribed interests) were classified as securities and the disclosure

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726 paras 5.2-5.3. Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 6, *Financial Markets and Investment Products: Promoting competition, financial innovation and investment* (1997) at 105 highlighted the role of disclosure regulation in assisting the price formation process and informed decision-making by investors.

727 CLERP 9 paper *Corporate disclosure: Strengthening the financial reporting framework* (2002), Section 8.5.6.

728 The disclosure requirements for certain secondary sales apply for anti-avoidance purposes. See Appendix 1 to this paper under **The disclosure test**.

729 CLERP 9 paper *Corporate disclosure: Strengthening the financial reporting framework* (2002), Section 8.5.6.

730 Former Part 7.12 Div 5.

731 Former s 92.

732 paras 5.9-5.21.

document for those interests was therefore a prospectus.[733] The disclosure provisions for securities were subsequently amended by the *Corporate Law Economic Reform Program Act 1999*. The shorter forms of disclosure introduced by the amendments applied to interests in managed investment schemes, which continued to be classified as securities.

The prospectus requirements, and the various shorter disclosure regimes for securities, are discussed in Section 10.4.2.

In 2002, the Product Disclosure Statement requirements, introduced by the *Financial Services Reform Act 2001* (FSRA), replaced the prospectus requirements as the disclosure regime for scheme interests.[734] In 2005, a shorter PDS regime was introduced as an optional alternative to the full PDS requirements. In 2012, another shorter PDS regime was introduced as the mandatory disclosure regime for certain schemes. The PDS requirements, including the shorter PDS regimes, are discussed in Section 10.4.3.

The scheme constitution also contains information that may be relevant to scheme investors. The contents of scheme constitutions are discussed in Sections 5.2.2 and 6.1, while Section 10.7.1 discusses disclosure issues associated with matters contained in scheme constitutions.

10.4.2 Disclosure requirements for securities

Overview

The legislation governing prospectuses originally contained detailed prescription of the content requirements for prospectuses.[735] With the introduction of the Corporations Law in 1991, this 'checklist' approach was replaced with a general disclosure requirement that prospectuses:

> … contain all such information as 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 corporation; and
>
> (b) the rights attaching to the securities.[736]

In essence, this remains the disclosure test for prospectuses.[737]

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733 Explanatory Memorandum to the Bill for the *Managed Investments Act 1998*, para 5.2.

734 Interests in managed investment schemes ceased to be included in the definition of 'securities' that applies to the fundraising provisions: s 92(4) definition of 'securities', s 700(1), s 761A definition of 'security'. The various definitions of 'securities' and the extent to which they apply to interests in managed investment schemes are discussed in Section 16.3 of this paper.

735 See, for instance, s 98 of the various State and Territory Companies Codes, which came into force in July 1981 in the Australian Capital Territory and the States and in July 1986 in the Northern Territory.

736 Former s 1022(1) of the Corporations Law. HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.211] observed that:

> Experience has suggested that checklists (especially when designed without adequate knowledge of the issuer's business) tended to emphasise the mechanical "ticking off" of items of investigation, in an unreflective exercise that ran the risk of overlooking matters of more material concern.

The same commentary also said (at [22.310]), in relation to the checklist approach:

> the courts did not develop any general duty to disclose all material relevant to the investment decision, and it was generally thought that the adequacy of disclosure was beyond challenge if all of the detailed prescriptions had been satisfied.

The Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* said (at para 2.16) that the general disclosure test was preferable to the checklist approach, which 'was easily circumvented by fundraisers and led to less meaningful disclosures to investors'.

Over the course of the 1990s, however, prospectus length and complexity proved to be a concern for retail investors and resulted in high costs for fundraisers.[738] These factors led to the introduction of shorter disclosure regimes for securities by the *Corporate Law Economic Reform Program Act 1999*, being:

- short form prospectuses[739]
- profile statements[740]
- offer information statements.[741]

In addition to these shorter disclosure regimes, a lower disclosure standard for prospectuses was introduced for offers that relate to continuously quoted securities.[742]

Prospectuses

General requirements

Chapter 6D requires that prospectuses satisfy a 'due diligence' standard by containing 'all the information that investors and their professional advisers would reasonably require to make an informed assessment' of:

- 'the rights and liabilities attaching to the securities', and
- 'the assets and liabilities, financial position and performance, profits and losses and prospects of the body' issuing the securities

but only:

- to the extent to which it is reasonable for investors and their professional advisers to expect to find the information in the prospectus, and
- if various persons involved in the offer actually knew the information or in the circumstances ought reasonably to have obtained the information by making enquiries (the due diligence requirement).[743]

In addition to this general due diligence disclosure requirement, a prospectus must contain the following specific information:[744]

- the terms and conditions of the offer
- details about certain interests, fees or benefits of any directors or proposed directors of the company, persons acting in a professional, advisory or other capacity in connection with the preparation or distribution of the prospectus, promoters,

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737 s 710.
738 See, for instance, *Financial System Inquiry Final Report* (1997) (the Wallis report) at 271, Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999*, paras 2.14, 2.16.
739 s 712.
740 s 714.
741 s 715.
742 s 713.
743 s 710.
744 s 711. A prospectus must also set out the information required by the regulations: s 711(8). There are no relevant regulations.
Also, since 30 September 2009, a prospectus issued by an unlisted disclosing entity should describe how it will comply with its continuous disclosure obligations: see Regulatory Guide 198 *Unlisted disclosing entities: Continuous disclosure obligations* at RG 198.15, RG 198.44.

underwriters (but not sub-underwriters) or financial services licensees involved in the fundraising

- a statement of what has been done about the admission to quotation of securities if the prospectus states or implies that they will be able to be traded on an Australian or overseas financial market

- a statement that no securities will be issued on the basis of the prospectus after the specified expiry date, which must not be later than 13 months after the date of the prospectus[745]

- a statement that a copy of the prospectus has been lodged with ASIC and ASIC takes no responsibility for the content of the prospectus.

The prospectus disclosure requirements in Chapter 6D continued to apply to shares and debentures after the FSRA came into effect.[746]

Transaction-specific prospectuses for continuously quoted securities

Prospectuses are subject to reduced disclosure requirements where they relate to continuously quoted securities.[747] As with prospectuses generally, these transaction-specific prospectuses must contain information to enable an informed assessment of the rights and liabilities attaching to the securities offered. However, they need only provide information about 'the assets and liabilities, financial position and performance, profits and losses and prospects of the body' if information falling into that category has been exempted from the continuous disclosure requirements. If there is no such information, the prospectus need only disclose information about 'the effect of the offer on the body'. The prospectus must also:

- state that, as a disclosing entity, the body is subject to regular reporting and disclosure obligations and that copies of documents lodged with ASIC may be obtained from, or inspected at, an ASIC office

- either:

  - inform people of their right to obtain a free copy of the most recent annual report, any subsequent half-year financial report and any subsequent continuous disclosure notices, or

  - include, or be accompanied by, a copy of the documents.

ASIC can prevent a body from using a transaction-specific prospectus if certain disclosure-related contraventions have occurred in relation to the body in the previous 12 months.

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745 The 13-month life for a prospectus was introduced by the *Corporate Law Economic Reform Program Act 1999*, to facilitate issuers rolling over prospectuses annually. The ALRC/CASAC report also recommended (at para 5.21) a 13 month, rather than a 12 month, life, as a prospectus issuer must otherwise issue a new prospectus slightly before the expiration of the 12 month period, to ensure there is always a current prospectus, with the result that the issue dates for prospectuses will become slightly earlier each year.

746 Chapter 6D applies to offers of 'securities'. The meaning of securities for this purpose is determined by the s 92(4) definition of 'securities', s 700(1) and the s 761A definition of 'security' and covers shares and debentures. See also the Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 14.4, 14.8, 14.18.

747 s 713 (prospectuses), definition of 'continuously quoted securities' in s 9. Section 713 also makes specific provision for options to acquire continuously quoted securities.

Short form prospectuses

The short form prospectus regime permits a prospectus simply to refer to a document that has been lodged with ASIC, rather than setting out the information that it contains.[748] Documents incorporated in this way are treated as being included in the prospectus, thus ensuring that they are subject to the content and liability rules for prospectuses.[749]

A short form prospectus must inform investors of their right to obtain a copy of any document lodged with ASIC and provide sufficient information for an investor to obtain a copy, which must be provided free of charge. A person may lodge a document with ASIC for the specific purpose of incorporating it into a prospectus: it is not necessary that the Corporations Act require the document to be lodged.

If the information is of interest to professional analysts or advisers or investors with similar specialist information needs, the short form prospectus must describe the contents of the document to which the prospectus refers and indicate that such information is of interest to those people.

Profile statements

The Corporations Act provides for the making of particular types of offers using a profile statement instead of a prospectus if ASIC so permits.[750] However, the obligation to prepare a prospectus remains.[751]

It was intended that industry specific profile statements would give investors the ability to make comparisons between similar products.[752] Before the exclusion of interests in a managed investment scheme from the securities fundraising provisions, ASIC approved the use of profile statements for many kinds of unlisted managed investment schemes.

A profile statement sets out limited key information about the company and the offer, being:

- the identity of the issuer
- the nature of the securities
- the nature of the risks involved in investing in the securities
- all amounts payable in respect of the securities (including fees and commissions)
- the expiry date, being no more than 13 months from the date of the prospectus
- a statement that no securities will be issued on the basis of the statement after the expiry date.[753]

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748 s 712.
749 s 712(3), Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act* 1999 para 8.8.
750 s 709(2). Profile statements were recommended by the *Financial System Inquiry Final Report* (1997) (the Wallis report) at 274-275.
751 s 709(2), (3).
752 Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* at para 8.11.
753 s 714. A profile statement must also contain any other information required by the regulations or by ASIC as a condition of approval. There are no relevant regulations and ASIC has not given any approvals.

As for a prospectus, a profile statement must indicate that a copy has been lodged with ASIC and that no responsibility is taken by ASIC for the content.

The disclosure standard for a profile statement is lower than for a prospectus, as lack of knowledge about a relevant matter is a defence to liability for a misleading or deceptive statement or an omission.[754]

Offer information statements

A body offering to issue securities may use an offer information statement instead of a prospectus if the total of all amounts raised by the body or specified related entities is $10 million or less.[755] The offer information statement is primarily intended to be a fundraising mechanism for small and medium sized enterprises, though it is not limited to those enterprises.[756]

An offer information statement should highlight that it is not a prospectus and has a lower level of disclosure than a prospectus and that investors should obtain professional investment advice before accepting the offer.[757] In addition, it must:

- identify the body
- identify the nature of the securities
- describe the business
- describe the proposed use of the funds raised
- state the nature of the risks involved in investing in the securities
- give details of all amounts payable in respect of the securities (including fees and commissions)
- state that:
  - a copy of the statement has been lodged with ASIC and ASIC takes no responsibility for the content of the statement
  - no securities will be issued on the basis of the statement after the specified expiry date, which must be no more than 13 months from the date of the statement
- include a recent audited financial report prepared in accordance with the accounting standards.[758] This requirement may have limited the utility of the offer information statement for small to medium-sized enterprises.[759]

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754 s 732.

755 s 709(4).

756 Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* at paras 2.33, 8.55 and 8.58.

757 s 715(1)(g), (h). Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* at para 8.57.

758 s 715. An offer information statement must also contain any other information required by the regulations. There are no relevant regulations.

759 HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.300] observed that:

It was not expected that the preparation of an offer information statement would involve external inquiries to ascertain information about matters on which disclosure is required.[760]

The disclosure standard for an offer information statement is lower than for a prospectus, as lack of knowledge about a relevant matter is a defence to liability for a misleading or deceptive statement or an omission.[761]

Supplementary disclosure for securities

There is a requirement for supplementary or replacement documents that correct or supplement information provided in prospectuses (including short form prospectuses), profile statements and offer information statements where:

- the relevant document contains a misleading or deceptive statement or an omission or where a new circumstance that would have required disclosure has arisen since the original document, and
- the statement, omission or circumstance is materially adverse from the point of view of an investor.[762]

A supplementary or replacement document can also be issued for other reasons[763] (for instance, if the person making the offer becomes aware that information in the disclosure document is not worded and presented in a clear, concise and effective manner[764]).

The subsequent document must be dated and state that it is a supplementary or replacement document, as the case may be, and identify the original document.[765]

10.4.3 Disclosure requirements for interests in schemes

Overview

The Product Disclosure Statement requirements for financial products (including interests in managed investment schemes) came into effect in 2002.

Subsequently, two new regimes providing for abbreviated Product Disclosure Statements for schemes were introduced, one in 2005 and the other in 2012.

The Short-Form PDS regime[766] was introduced for all managed investment schemes in 2005, to provide an optional alternative to giving the full PDS (which still had to be

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Many of these bodies are not required to have their financial statements audited, and the appointment of an auditor only for the purposes of the offer information statement is likely to be disproportionately expensive. ASIC has discussed the circumstances in which it is prepared to modify the requirement, in RG 157 *Financial reports for offer information statements*, from which it appears that a modification will be available only in very limited circumstances.

760 Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* at para 8.56.

761 s 732.

762 s 719. That section says that a person 'may' lodge a supplementary or replacement document with ASIC, but Note 1 to the section points out that it is 'an offence to continue making offers after the person has become aware of a misleading or deceptive statement, omission or new circumstance that is materially adverse from the point of view of an investor unless the deficiency is corrected' (s 728).

763 Note 3 to s 719.

764 s 719(1A).

765 s 719(2). A supplementary document must also identify any other supplementary documents and state that it is to be read together with all previous documents.

766 Part 7.9 Div 3A (containing ss 1017H-1017K), as inserted by Corp Regs 7.9.61AA, Schedule 10BA Part 3 Item 3.1.

available to those investors who requested it). The Explanatory Statement to the regulations that introduced that regime[767] stated that:

> PDSs have as a rule turned out to be complex and lengthy documents. Consumer feedback suggests that the average retail investor finds it difficult to absorb the large volume of information in some PDSs, and is therefore deterred from using the information to make investment decisions.

In June 2012, a different shorter PDS regime, applicable to most simple managed investment schemes ('simple schemes'),[768] commenced.[769] It is compulsory for those schemes.

ASIC has issued guidance on the disclosure to be included in disclosure documents for certain types of managed investment scheme.[770]

Full Product Disclosure Statements

General requirements

The PDS requirements in Part 7.9 Div 2 are based on a 'directed disclosure' approach, which:

- involves 'a list of topics under which information, if relevant to a particular financial product, must be included in the Product Disclosure Statement ... supplemented by a requirement to include any other material information actually known to the product issuer'[771]

- seeks to balance the need for the purchaser to have sufficient information to make an informed decision and compare products against the concern that they may be provided with more information than they can comprehend.[772]

A Product Disclosure Statement must include the following statements, and such of the following information as a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product:[773]

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767 *Corporations Amendment Regulations 2005 (No. 5)*.

768 'Simple managed investment scheme' is defined in Corp Reg 1.0.02.

769 *Corporations Amendment Regulations 2010 (No. 5)*, as amended by *Corporations Legislation Amendment Regulations 2011 (No. 2)*.
Paragraph 1020G(1)(c) confers the power to enact regulations varying the operation of the disclosure provisions in Part 7.9. In reliance on this power, Corp Reg 7.9.11V modifies Part 7.9 in the manner set out in Part 5C of Schedule 10A to the Corporations Regulations. Item 5C.2 in Schedule 10A replaces s 1013C(1) as enacted with a new s 1013C(1)-(1F). The replacement s 1013C(1)(a), (b) confers the power to enact regulations governing the statements and information to be contained in, and the form of, a simple scheme PDS. In reliance on this power, Corp Reg 7.9.11W prescribes the information, statements and form contained in Schedule 10E.
The shorter PDS requirements for simple managed investment schemes do not apply where the interests in the scheme are traded on a financial market or are stapled securities, or the scheme allows the investor to direct how money invested in the scheme is to be invested (Corp Reg 7.9.11S(2)-(4)).
For ASIC interim relief exempting various funds, including multifunds and hedge funds, from the shorter PDS regime, see ASIC Class Orders [CO 12/749], [CO 12/1592], [CO 13/632], [CO 13/1128] and [CO 14/23].

770 Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors*, Regulatory Guide 46 *Unlisted property schemes: Improving disclosure for retail investors*, Regulatory Guide 231 *Infrastructure entities: Improving disclosure for retail investors*, Regulatory Guide 232 *Agribusiness managed investment schemes: Improving disclosure for retail investors*, Regulatory Guide 240 *Hedge funds: Improving disclosure*.

771 Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 4.35, 14.21.

772 Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 14.71.

773 ss 1013C, 1013D. The factors in s 1013D are discussed in the Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 14.75-14.92. Corp Reg 7.9.14C contains more detail about the information about labour standards or environmental, social or ethical considerations that a PDS must contain.

- a statement setting out the name and contact details of the issuer and, where relevant, the seller of the financial product[774]
- the benefits of the product
- significant risks associated with the product[775]
- the cost of the product
- the quantum and date for payment of any amounts that will or may be payable after acquisition
- any expenses or charges deductible from a common fund
- any commission, or other similar payments, that may affect the return to the product holder[776]
- any other significant characteristics or features of the product or of the rights, terms, conditions and obligations attaching to the product
- the dispute resolution system
- general information about significant taxation implications
- any cooling-off regime applicable to acquisitions of the product
- a statement of how any other information provided may be accessed
- the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment.

A PDS must also contain any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product.[777]

A Product Disclosure Statement must also contain any other statements or information required by the regulations: s 1013D(1)(k). There are no regulations relevant to managed investment schemes. The ALRC/CASAC report advocated 'rules to ensure that the operator of the scheme gives investors all the information relevant to the assessment of risk that the operator has available to it' (para 2.10).
Also, since 30 September 2009, a PDS issued by an unlisted disclosing entity should describe how it will comply with its continuous disclosure obligations: see Regulatory Guide 198 *Unlisted disclosing entities: Continuous disclosure obligations* at RG 198.15, RG 198.44.
Where a financial product (which could include an interest in a managed investment scheme) is offered or issued by a discretionary mutual fund, a Product Disclosure Statement must also be given to a wholesale client: Corp Reg 7.9.07A.

774 The ALRC/CASAC report recommended that a scheme disclosure document identify the RE (para 5.8).

775 In *Woodcroft-Brown v Timbercorp Securities Limited (in liq)* [2011] VSC 427, the Court said (at [126]):

> s 1013D does not require disclosure of information concerning any and all possible risks. Had that been so, the section would have so stated. Instead, only risks which are relevant to the product, significant and which one would reasonably expect to see disclosed in the Product Disclosure Statement need be included.

This passage was quoted in a statement of principles by the Court in *Almonds Investors Ltd v Emanouel* [2012] VSC 413 at [38].

776 The *Financial System Inquiry Final Report* (1997) (the Wallis report) at 271 said that 'consumers need information about fees, commissions (including trailing commissions) and the remuneration paid to their financial advisers or brokers so that they can determine whether a recommendation is skewed in favour of a particular product'.

777 ss 1013C, 1013E. This may include, for instance, identification of the scheme's custodian and a description of its role: ASIC Report 291 *Custodial and depository services in Australia* (July 2012), para 18.

The information to be included in a PDS for interests in a managed investment scheme is only information actually known to the RE and various other persons involved in an issue (or certain sales) of the interests.[778] Also, information is not required to be included in a PDS 'if it would not be reasonable for a person considering, as a retail client, whether to acquire the product to expect to find the information in the Statement'.[779]

Transaction-specific PDSs for continuously quoted securities

PDSs are subject to reduced disclosure requirements where they relate to continuously quoted securities.[780] These transaction-specific PDSs need not contain any information included in an annual or a half-year financial report lodged with ASIC or in a continuous disclosure notice. A transaction-specific PDS must:

- state that, as a disclosing entity, the issuer of the product is subject to regular reporting and disclosure obligations and that copies of documents lodged with ASIC may be obtained from, or inspected at, an ASIC office
- inform people of their right to obtain a free copy of the relevant financial report or continuous disclosure notice.[781]

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778 Under s 1013C(2), information required by ss 1013D and 1013E need only be included in a PDS to the extent to which it is actually known to the 'responsible person' and various other persons.
The responsible person is the person who, or on whose behalf, a PDS for a financial product is required to be prepared (definition of 'responsible person' in s 1011B, s 1013A(3)).
In the case of an issue of interests in a registered scheme, the responsible person is the RE, given that:
- the obligation falls on the 'issuer' (s 1013A(1))
- the issuer is 'the person responsible for the obligations owed, under the terms of the facility that is the product' (s 761E(4), following on from the definition of 'issuer' in s 761A)
- that person is the RE of a registered scheme, which is to operate the scheme and perform the functions conferred on it by the scheme's constitution and the Corporations Act (s 601FB(1); see P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at [¶62-240]).

In the case of a sale of interests in a registered scheme that constitutes an off-market sale by the controller, the responsible person is the person who controls the RE, given that:
- the obligation falls on the 'the person making the offer to sell' the interest in the scheme (s 1013A(2))
- the person making the offer to sell is a person who controls the issuer (s 1012C(5); see s 50AA for the definition of 'controls'), which, as noted in the previous paragraph of this footnote, is the RE (see P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at [¶62-260]).

The other persons whose knowledge is relevant to the content of a PDS are underwriters, persons who participated in the preparation of the PDS, persons who consented to a statement of theirs being included in the PDS (see s 1013K), persons who have performed a professional or advisory function and, if any of those persons is a body corporate, any director of that body corporate (s 1013C; cf s 711 for prospectuses). For a sale that amounts to an indirect issue, the knowledge of the issuer is also relevant.

779 s 1013F.

780 s 1013FA. See also the definition of 'continuously quoted securities' in s 9. Section 1013FA was introduced by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* to permit transaction-specific PDSs (see the Explanatory Memorandum to the Bill for the 2004 Act, paras 5.528-5.529). This section implemented Proposal 28 in the CLERP 9 paper *Corporate disclosure: Strengthening the financial reporting framework* (2002), which was aimed at ensuring that the provision for transaction-specific PDSs was in line with that for transaction-specific prospectuses (see the discussion in that paper at pp 154-156).
It appears that s 1013I, which was introduced with the FSRA amendments in 2002, was intended to permit transaction-specific PDSs (see the Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 18.10). However, instead of permitting transaction-specific PDSs that may exclude the specified categories of previously disclosed information, s 1013I merely requires that PDSs include statements that draw attention to previously disclosed information and the means by which investors can obtain it. The resulting gap was filled by s 1013FA.

781 There is no option for a transaction-specific PDS to include, or be accompanied by, a copy of the document instead of informing people of their right to obtain the document. By contrast, s 713 (the securities provision allowing transaction-specific prospectuses) provides that a prospectus can either inform people of their right to a free copy of the relevant document (alternative 1) or include, or be accompanied by, a copy of the document (alternative 2) (s 713(4)(b)).

ASIC can prevent a body from using a transaction-specific prospectus if certain disclosure-related contraventions have occurred in relation to the body in the previous 12 months.

Incorporation by reference

In 2007, an incorporation by reference regime was introduced to provide an alternative means of satisfying certain content requirements for full PDSs.[782] The prerequisites for use of this regime are:

- the incorporated material must be in writing and publicly available in a document other than the PDS (public availability might be through electronic sources such as the Internet[783])
- the incorporated material must not be in a Short-Form PDS, which is already an abbreviated document
- the PDS must give sufficient information to enable a person to identify the incorporated material and decide whether or not to obtain and read it
- the PDS must state that the incorporated material is available on request at no charge.

Incorporated material is taken to be included in the PDS.[784]

The following core information must be included in the PDS itself, not incorporated by reference:

- a summary description of the purpose and key features of the product
- a summary description of the key risks of the product
- the name and contact details of the issuer or seller[785]
- certain information about fees and costs
- a Consumer Advisory Warning
- the dispute resolution system and how that system may be accessed
- any cooling-off regime.[786]

In relation to PDSs, s 1013I contains elements similar to those found in s 713 and therefore contains both alternatives. However, s 1013I does not permit transaction-specific PDSs, as explained in the previous footnote. Section 1013FA, which permits transaction-specific PDSs, provides only for alternative 1.

782 Corp Reg 7.9.15DA. This regulation was introduced by the *Corporations Amendment Regulations 2007 (No. 10)*. See also the commentary on this regulation in the Explanatory Statement to the *Corporations Amendment Regulations 2007 (No. 10)*.

There is a separate incorporation by reference regime for simple managed investment schemes: see the discussion later in this section under the heading ***Product Disclosure Statements for simple schemes***.

783 Explanatory Statement to the *Corporations Amendment Regulations 2007 (No. 10)*, commentary on Item [4] – Regulations 7.9.15DA, 7.9.15DB and 7.9.15DC.

784 Corp Reg 7.9.15DA(3).

785 For the circumstances in which a seller is required to give a PDS, see Appendix 1 to this paper under **The disclosure test**.

786 Corp Reg 7.9.15DA(4).

Other content provisions

In addition to the required information, a Product Disclosure Statement may:

- include other information, or
- refer to other information that is set out in another document[787] (this discretionary additional information is distinct from information included by reference in satisfaction of a statutory disclosure requirement).

Supplementary PDSs

There is provision for Supplementary Product Disclosure Statements, to correct misleading or deceptive statements in, or omissions from, a PDS and to update or add to information in a PDS.[788]

Supplementary PDSs are the principal method for these purposes. A replacement PDS regime was added by the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007*[789] to allow for the situation where the scheme interests are part of a stapled securities structure: a stapled entity can issue a replacement PDS for the scheme interests when it issues a replacement prospectus for the company securities.

ASIC Good Disclosure Principles

ASIC has set out Good Disclosure Principles for Product Disclosure Statements 'to help product issuers comply with the disclosure requirements and also promote good disclosure outcomes for consumers'.[790] These principles are that disclosure should:

- be timely[791]
- be relevant and complete[792]
- promote product understanding[793]
- promote product comparison[794]
- highlight important information[795]
- have regard to consumers' needs.[796]

Short-Form Product Disclosure Statements

A person who is required to provide a PDS (including the issuer of an interest in a scheme[797]) may instead provide a Short-Form PDS.[798] However, the need to prepare a

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787 s 1013C(1)(b).
788 Part 7.9 Div 2 Subdiv D.
789 Part 7.9 Div 2 Subdiv DA, Explanatory Memorandum to the Bill for the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* para 5.27.
790 Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* at RG 168.2.
791 RG 168.4, RG 168.60-RG 168.63.
792 RG 168.4, RG 168.64-RG 168.70.
793 RG 168.4, RG 168.71-RG 168.86.
794 RG 168.4, RG 168.87-RG 168.89.
795 RG 168.4, RG 168.90-RG 168.96.
796 RG 168.4, RG 168.97-RG 168.104.
797 Parties other than the issuer of a scheme interest may also have an obligation to give a PDS: see the definition of 'regulated person' in s 1011B.
798 s 1017H(1).

full PDS, as well as the Short-Form PDS, remains, given that the full PDS must be provided to investors on request.[799]

The Short-Form PDS regime facilitates the provision of a more succinct disclosure document in two ways.

First, a Short-Form PDS need only contain summaries[800] of statements and information contained in the full PDS[801] (but must also contain information about obtaining a copy of the full PDS[802]). These summaries cover most of the items to be contained in a full PDS.[803] This information was regarded as 'sufficient to give retail clients a reasonable understanding of the key features of the product, including what costs they will incur in acquiring the product'.[804]

Secondly, the Short-Form PDS may incorporate by reference other information that is set out in the full PDS or in the Financial Services Guide (FSG).[805] The reference must identify the relevant PDS or FSG or the part that contains the information.[806]

A Short-Form PDS may also include other information.[807]

There is provision for Supplementary Short-Form PDSs.[808]

The Short-Form PDS regime is intended:

> to give financial product providers the flexibility to create a document that is not only shorter, but also more tailored to the individual product, and that is written in a manner that is more appealing and informative for the retail client.[809]

It also provides the opportunity for issuers to save printing and dissemination costs. However, there are no savings in preparation costs, given that both the full and the Short-Form PDS must be prepared.

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799 s 1017H(2).

800 The Explanatory Statement to the *Corporations Amendment Regulations 2005 (No. 5)* said that:

> The term 'summary' in this context is intended to mean a condensed and straightforward account of certain key content items that are required (among others) to be included in the PDS.

801 s 1017I(1)(a). In addition to the cost-related information (including fees) required in the summary of the relevant information from the full PDS, see also s 1017I(2) (as inserted by Corp Regs Schedule 10BA Part 3 Item 3.1), Part 2 of Schedule 10 of the Corporations Regulations, s 1013D(4)(c), Corp Reg 7.9.16L, s 1015C(5)(b), Corp Reg 7.9.16N). The question of fees disclosure is discussed in Section 10.4.6 of this paper.

802 s 1017I(1)(b).

803 A Short-Form PDS does not have to summarise:

- general information about significant taxation implications (s 1013D(1)(h)), or
- the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment (s 1013D(1)(l)).

804 Explanatory Statement to the *Corporations Amendment Regulations 2005 (No. 5)*.

805 s 1017I(3)(b)-(6). The FSG provides general information about a service provider. The FSG requirements, contained in Part 7.7 Div 2, were introduced by the FSRA at the same time as the PDS requirements, as were the requirements relating to the statement of advice (Part 7.7 Div 3), which provides a written record of personal financial advice and discloses information relevant to such advice.

806 s 1017I(4).

807 s 1017I(3)(a).

808 Part 7.9 Div 3B (containing ss 1017L-1017Q), as inserted by Corp Regs 7.9.61AA, Schedule 10BA Part 3 Item 3.1.

809 Explanatory Statement to the *Corporations Amendment Regulations 2005 (No. 5)*, under the heading *Schedule 3 – Proposal 3*.

Shorter Product Disclosure Statements for simple schemes

Definition of simple managed investment scheme

Simple schemes are those schemes at least 80% of whose assets are:

- invested with a bank and available either immediately during normal business hours or at the end of a fixed term not exceeding three months, or
- invested in such a way that the RE can reasonably expect to realise the investment at market value within 10 days.[810]

Form and content requirements

The PDS for a simple scheme (other than a scheme that is excluded such as a listed scheme or a platform), like the PDS for any other scheme, must be worded and presented in a clear, concise and effective manner.[811] It must also be entitled 'Product Disclosure Statement'[812] and dated.[813]

However, the shorter PDS regime for simple schemes imposes strict requirements concerning form and content that substitute for the full PDS requirements.[814] The key requirements for these shorter PDSs are:

- each PDS must relate to only one simple managed investment scheme[815]
- the PDS must satisfy maximum length and minimum font size criteria[816]
- the PDS must include sections that:
  - contain specified information about each of eight stipulated matters (the RE, how the scheme works, benefits of the scheme, risks of schemes, how money is invested, fees and costs, how schemes are taxed and how to invest in the scheme, the cooling-off period and the procedure for making complaints)
  - are identified by stipulated numbered headings, which must be set out in a table of contents.[817]

The prescribed section headings are intended to make it easier for consumers to find important information in the PDS and compare products, while the content requirements

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[810] Definition of 'simple managed investment scheme' in reg 1.0.02. Cash deposits, term deposits, government bonds and high grade commercial paper would ordinarily satisfy the liquidity and capital certainty threshold required by this definition. Managed investment schemes that invest in less liquid assets, such as schemes investing directly in real estate or mortgages, are not simple schemes: Explanatory Statement to the *Corporations Amendment Regulations 2010 (No. 5)*.

[811] s 1013C(3). In addition, a person required to a give a PDS to a vision-impaired person must comply with the *Disability Discrimination Act 1992*.

[812] s 1013B.

[813] s 1013G.

[814] Modified s 1013C(1), as inserted by Corp Reg 7.9.11V together with Schedule 10A Item 5C.2 and Corp Reg 7.9.11W together with Schedule 10E.

[815] Modified s 1013C(1)(c), as inserted by Corp Reg 7.9.11V together with Schedule 10A Item 5C.2.

[816] Schedule 10E Item 1. For instance, the maximum page length is 8 pages if the PDS is printed on A4 pages. Given the objective of making PDSs user friendly and easy to read, ASIC interprets this requirement as meaning 8 single-sided pages or 4 double-sided pages: Information Sheet 155 *Shorter PDSs: Complying with requirements for superannuation products and simple managed investment schemes* (June 2012).

[817] Schedule 10E Items 2-10. There must also be a table of contents using the specified titles: Item 2.

ensure that consumers have the key information they need to make an investment decision.[818]

A simple scheme PDS is not subject to the requirement applicable to full PDSs that the PDS 'contain any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product'.[819]

Incorporation by reference

The shorter PDS provisions contain an incorporation by reference regime.[820]

The matter incorporated must be in writing, clearly distinguishable from matters that are not incorporated and publicly available.[821] The person who has responsibility for the PDS must identify the incorporated matter (including each version of the matter, if relevant) and ensure that each person relying on the PDS can have access to the matter (including each version, if relevant) reasonably easily and reasonably quickly.[822]

The PDS must advise investors to read the incorporated matter before making a decision and point out that the incorporated material may change between the time the PDS is read and the time the product is acquired. The PDS and the document containing the incorporated matter must each identify the other document.

Material incorporated by reference is deemed to be part of the shorter PDS and the full range of liability and enforcement provisions of the law apply to it.[823]

The regulation that creates the incorporation by reference regime provides that the regime is only available if the regulations require or permit its use.[824] There are regulations that permit incorporation by reference for various matters (either as a way of satisfying a

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818 ASIC Information Sheet 133 *Shorter PDS regime: Superannuation, managed investment schemes and margin lending* at 2, Information Sheet 155 *Shorter PDSs: Complying with requirements for superannuation products and simple managed investment schemes* at 4.

819 s 1013E. This section is omitted from the PDS regime for simple schemes by Schedule 10A Item 5C.2, which modifies the law as authorised by Corp Reg 7.9.11V (enacted pursuant to s 1020G(1)(c)). This paper at Section 14.2 Item 4 raises for consideration whether the disclosure obligation in s 1013E should be extended to simple managed investment schemes.

820 s 1013C(1B) as inserted by Corp Reg 7.9.11V together with Schedule 10A Item 5C.2, Corp Reg 7.9.11X.

821 Corp Reg 7.9.11X. Incorporated information needs to be distinguished from non-incorporated information, as the two are subject to different liability and enforcement regimes: Explanatory Statement to the *Corporations Amendment Regulations 2010 (No. 5)*, commentary on Corp Reg 7.9.11X.

822 The ability to request and receive a hard copy of the PDS and incorporated material (Corp Reg 7.9.11Z) satisfies the requirements for incorporated matter to be publicly available and easily and quickly accessible: Explanatory Statement to the *Corporations Amendment Regulations 2010 (No. 5)*, commentary on Corp Reg 7.9.11X. The Explanatory Statement also states:

> It is also expected that the incorporated material is, to the extent practical, consistent with the PDS in terms of its headings and content for comparability and ease of reading. This will at the same time reduce the risk of claims of misleading or deceptive conduct based on variations in content between the shorter PDS and incorporated information.
>
> If a website link is provided, this should link to the material with as few steps as possible. For example, linking directly to the material, or via a prominent link on a splash page is one way to achieve this and would be seen to be reasonably accessible. If a website link leads only to the home page of a provider's website, and a person needs to navigate a number of links on the site to locate the material, this is not considered to be reasonably quickly and easily accessible.

823 s 1013C(1C) as inserted by Corp Reg 7.9.11V together with Schedule 10A Item 5C.2, ASIC Information Sheet 155 *Shorter PDSs: Complying with requirements for superannuation products and simple managed investment schemes* at 5.

824 Corp Reg 7.9.11X(2).

requirement or as a means of supplying further information about matters dealt with in the PDS).[825] Currently, no regulations require the use of incorporation by reference.

Unlike the provision for incorporation by reference that applies to PDSs other than shorter PDSs, a matter may be incorporated by reference into a shorter PDS in the form that it takes from time to time.[826]

Other content provisions

In addition to material incorporated by reference (which is part of the PDS), the shorter PDS may refer to other information that is set out in another document[827] (which does not form part of the shorter PDS, although it is still subject to certain requirements under the Corporations Act and Corporations Regulations, such as the prohibition on misleading or deceptive conduct[828]).

A simple scheme PDS may also include additional sections and information after the mandated sections, provided that the PDS does not thereby exceed the maximum page length.[829]

No Supplementary PDS for simple schemes

The Supplementary PDS regime is not available for simple schemes.[830] Instead, any inadequacies in a simple scheme PDS must be rectified by the preparation of a new PDS, given that a PDS for a simple scheme:

- is a very short document
- allows information that changes frequently or regularly to be incorporated by reference
- only has to be amended rarely and only if there are major changes to the scheme.[831]

10.4.4 Analysis and discussion

CAMAC's general approach to the regulation of managed investment schemes is that the regulatory regime for schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently, given that these two types of

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825 The items in Schedule 10E that permit incorporation by reference as a way of satisfying a requirement are:
- describing a particular investment manager, if there is more than one (Item 3(2))
- providing certain information about investment options and the fees and costs of those options (Items 7(6), (7), 8(10)).

The items in Schedule 10E that permit incorporation by reference as a means of supplying further information about matters dealt with in the PDS relate to:
- the acquisition and disposal of interests (Item 4(3))
- features and benefits of the particular scheme or simple schemes generally (Item 5(2))
- significant risks of schemes (Item 6(4))
- fees and costs (Item 8(10))
- taxation matters relating to the particular scheme and to schemes generally (Item 9(3))
- cooling-off periods, complaints and dispute resolution (Item 10(2)).

826 s 1013C(1B), as inserted by Corp Reg 7.9.11V together with Schedule 10A Item 5C.2. See also Explanatory Statement to the *Corporations Amendment Regulations 2010 (No. 5)*, commentary on Corp Reg 7.9.11U.

827 s 1013C(1E), as inserted by Corp Reg 7.9.11V together with Schedule 10A Item 5C.2.

828 s 1013C(1F) and the Note to that provision, as inserted by Corp Reg 7.9.11V together with Schedule 10A Item 5C.2, s 1041H.

829 Schedule 10E subclause 2(4). The maximum length is set out in subclause 1(1).

830 Corp Reg 7.9.11U(1). There was a continuing role for Supplementary PDSs for simple schemes in the transitional period, which ended in June 2012: Corp Reg 7.9.11U(2).

831 Explanatory Statement to the *Corporations Amendment Regulations 2010 (No. 5)*, commentary on Corp Reg 7.9.11U.

commercial enterprise are sometimes available in the same markets and perform similar functions.

The Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* gave the following explanation of the policy underlying the Product Disclosure Statement disclosure requirements for financial products other than shares and debentures:

> The provisions … seek to achieve regulatory neutrality as between the competing investment vehicles of managed investments, superannuation and the investment components of life insurance. This is achieved by taking managed investments out of the fundraising provisions of the existing Corporations Act and subjecting them to the same directed disclosure requirements as superannuation and the investment components of life insurance.[832]

The CLERP 9 paper *Corporate disclosure: Strengthening the financial reporting framework* (2002) noted that the principal reason for not extending the harmonized disclosure arrangements for financial products introduced by the FSRA to shares and debentures was that the *Corporate Law Economic Reform Program Act 1999* had only recently amended the Chapter 6D fundraising requirements for securities.[833] That paper suggested that:

> Potential harmonisation and other general improvements may lead to more effectively targeted disclosure regimes.[834]

Since the introduction of the FSRA, managed investment schemes have grown in size and complexity, with income from distributions on their scheme holdings and capital gains on those holdings performing a similar economic function to dividends and capital gains on company securities. Investment portfolios now generally include both types of investments (as well as banking, insurance and superannuation products).

It may therefore be timely to compare and contrast the various disclosure standards that now apply to the different types of financial product, identify some of the themes arising from developments in disclosure regimes since the managed investment provisions in Chapter 5C were introduced in 1998 and assess whether the corporate and scheme disclosure regimes might be more closely aligned, in accordance with CAMAC's general approach.

The disclosure standard

The prospectus disclosure requirement is a general disclosure obligation, supplemented by a small number of specific disclosure requirements. By contrast, the PDS requirements take a directed disclosure approach involving a list of items that must be disclosed, supplemented by a limited general disclosure obligation.[835] The shorter PDS regime for

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832 para 14.21.
833 Section 9.1.
834 ibid.
835 The directed disclosure approach adopted for PDSs in relation to financial products other than shares and debentures was seen as a middle ground between the due diligence approach in the prospectus provisions and a 'Key Features Statement' approach requiring disclosure under specific headings that was used for superannuation products before the FSRA came into effect: Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 14.19-14.20. The Key Features Statement approach adopted in relation to superannuation was reflected in a determination under s 153 of the *Superannuation Industry (Supervision) Act 1993*. That provision was repealed by the *Financial Services Reform (Consequential Provisions) Act 2001*, in view of the introduction of the PDS requirements in Part 7.9 of the Corporations Act: Explanatory Memorandum to the Bill for the *Financial Services Reform (Consequential Provisions) Act 2001* para 5.3.

simple managed investment schemes represents an even stronger application of the directed disclosure approach, given that it contains a more detailed list of disclosure requirements, more specific direction about how information is to be presented and no general disclosure obligation.

The limited general disclosure obligation applicable to PDSs[836] (other than shorter PDSs[837]) requires disclosure of 'any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product'. While this appears similar to the general disclosure obligation applicable to prospectuses, it only requires disclosure of information actually known to the persons who have responsibility for the PDS.[838] It 'is not intended to require product issuers to undertake a due diligence exercise to discover all material information'.[839] By contrast, the prospectus requirements impose a due diligence requirement to disclose information that in all the circumstances the issuer ought reasonably to have obtained by making inquiries.[840]

Another matter that is relevant to those who prepare disclosure documents is that the preparer of a PDS must take into account only the information requirements of retail clients, whereas the preparer of a prospectus must take into account the information requirements of investors and their professional advisers.[841]

There is a lower disclosure standard for some of the shorter securities disclosure documents. Profile statements and offer information statements need only contain information actually known to the preparer of the document.[842]

Past consultations and reviews provide various views on whether it is appropriate for scheme interests to be governed by the prospectus regime.

Submissions to the Collective Investments Review conducted by the Australian Law Reform Commission and the Companies and Securities Advisory Committee (CAMAC's predecessor) indicated support for applying the general disclosure obligation for prospectuses to scheme interests.[843] However, the ALRC/CASAC report also recommended that the prospectus requirement should be modified for schemes to require prospectus issuers to provide information relevant to the nature of, as well as the extent of, the risks of participating in a scheme.[844] This type of information is covered by the current PDS requirements. That report also indicated that holders of scheme interests may have a greater need for information than many company shareholders, given that schemes are

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The various approaches were said to reflect 'tensions between the desire to give consumers all the information they require to make a decision and the need to ensure that consumers can, and do, read and understand the information given to them': Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 14.19.

836 s 1013E.

837 Pursuant to Corp Reg 7.9.11V together with Schedule 10A Item 5C.3, s 1013E does not apply to shorter PDSs for simple managed investment schemes. This paper at Section 14.2 Item 4 raises for consideration whether this disclosure obligation should be extended to simple managed investment schemes.

838 s 1013C(2).

839 Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 14.20. See also para 14.74.

840 s 710.

841 Compare s 710 (prospectuses) with ss 1012A, 1012B, 1013C (PDSs). See Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 14.74, 14.94.

842 Lack of knowledge about a relevant matter is a defence to liability for a misleading or deceptive statement or an omission: s 732.

843 ALRC/CASAC report para 5.11.

844 ibid. Footnote 28 noted that the relevant provision at that time, reg 7.12.12, referred 'only to the extent of risks involved in scheme participation'.

typically characterized by a more significant separation of ownership and control than trading corporations.[845]

On the other hand, some public submissions during the development of the FSRA, while supportive of harmonized and consistent disclosure obligations, considered that it would be undesirable to introduce prospectus type requirements to products that do not warrant that level of disclosure (though managed investment products were not specifically identified in this context).[846]

A final matter is that the current bifurcation between the disclosure regime for interests in managed investment schemes and that for company securities appears to have resulted in investors who acquire an indirect interest in securities under a custodial arrangement[847] having no right to either a prospectus or a PDS in certain circumstances.[848] Ensuring that these investors receive disclosure, with a disclosure standard appropriate to that form of investment, should be part of any reassessment of the disclosure requirements, even if the current separate regimes for company shares and scheme interests are retained.

Comparability

Comparability of financial products is an important factor in determining disclosure standards. It was a consideration in the development of the shorter securities regimes,[849] the FSRA reforms[850] and the shorter PDS regime for simple managed investment schemes.[851]

Shorter disclosure documents

The legislation provides for different types of shorter disclosure document (short form prospectuses, profile statements, offer information statements, Short-Form PDSs and shorter PDSs for simple managed investment schemes).

The regimes differ in relation to whether the shorter disclosure document is:

- an additional document that can be distributed to investors who do not require the full document (as with profile statements, which do not remove the requirement to prepare

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845 id at para 5.2.

846 CLERP 9 paper *Corporate disclosure: Strengthening the financial reporting framework* (2002) Section 9.2.2.

847 A 'custodial arrangement' is defined (s 1012IA(1)) as having the following elements:
- the client gives an instruction to acquire a particular financial product
- the provider or a person with whom the provider has an arrangement acquires, or arranges the acquisition of, the financial product
- either the financial product is held on trust for the client or a nominated person or the client or a person nominated by the client has an interest in, or benefits from, the product.

848 The Corporations Act requires that a person receive a Product Disclosure Statement when the person is to obtain an indirect interest in a financial product under a custodial arrangement if the person would have received a PDS for a direct acquisition (s 1012IA). While the definition of 'financial product' in Chapter 7 generally covers securities (definition of 'financial product' in s 761A, s 764A(1)(a)), securities (other than warrants) are excluded from the Product Disclosure Statement requirements in Part 7.9 (s 1010A, Corp Reg 7.9.07A), given the alternative disclosure regime for securities in Chapter 6D. However, the prospectus disclosure requirements of Chapter 6D do not cover the acquisition of an indirect interest in securities under a custodial arrangement unless the client acquires a legal or equitable interest in the securities which is itself a security (ss 92(4), 761A). ASIC has established a disclosure obligation for certain types of custodial arrangement by modifications under ASIC Class Orders [CO 13/763] and [CO 13/760].

849 Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* para 2.17.

850 Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 14.30, Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 2.38. See also Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 6, *Financial Markets and Investment Products: Promoting competition, financial innovation and investment* (1997) Proposal No. 7 — Disclosure, *Financial System Inquiry Final Report* (1997) (the Wallis report) rec 8.

851 Explanatory Statement to the *Corporations Amendment Regulations 2010 (No. 5)*.

a full prospectus, and Short-Form PDSs, where the full PDS must be available for investors who request it) (Option 1), or alternatively

- an alternative to the full disclosure document (as with short form prospectuses) or a shorter disclosure document in its own right (as with transaction-specific prospectuses and PDSs and shorter PDSs for simple managed investment schemes) (Option 2).

The benefits of Option 1 are:

- a reduction in the burden of information for investors who do not want to read the full range of material available
- a saving in distribution costs for those required to prepare the document.[852]

The potential for a saving in distribution costs may become progressively less significant as electronic distribution becomes more common, especially with the increasing use of tablet devices to read documents without having to print them.

Option 2 would have the same benefits as Option 1 and, in addition, a saving in preparation costs for those required to prepare the document. Preparation costs may often be the most significant costs involved in preparing a disclosure document.

In some cases, the legislation promotes shorter disclosure documents by permitting incorporation by reference, which reduces the length of the documents, while ensuring that investors have access to relevant information.[853]

The various incorporation by reference regimes differ in relation to what information should be permitted to be incorporated. Short form prospectuses can incorporate documents that have been lodged with ASIC. PDSs can incorporate any written publicly available material (though certain key matters must be dealt with in the PDS itself). Short-Form PDSs can only incorporate material from the full PDS or the Financial Services Guide. A shorter PDS for simple schemes may only satisfy disclosure obligations through incorporation by reference when specifically permitted to do so by the regulations.

One commentary has expressed reservations about incorporation by reference:

> ... extensive use of incorporation by reference may well be antithetical to a clear, concise and effective presentation. If the information is not material to the investment decision, it need not be disclosed anywhere. If material information is incorporated by reference, investors who read the prospectus are required to make a choice as to whether to expend the effort and possible cost of chasing up the reference, or run the risk of not receiving material information that might have influenced their decision. In many circumstances the likelihood that a prospectus presents information in a clear, concise and effective manner will be enhanced by having the information in a single document which the investor can read through without the distraction of references.[854]

Also, different investors may have different information needs and may reasonably regard different information as relevant to them. They may also have different levels of willingness to seek additional information.

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852 Cost savings were emphasised in the Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* (para 2.17).

853 ASIC Information Sheet 155 *Shorter PDSs: Complying with requirements for superannuation products and simple managed investment schemes* (at 4).

854 HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.251].

A contrary view might be that, provided the core PDS contains the key information and is short and easy to read, it does not matter how much additional information is available for those who want it. Also, those investors who rely on professional advisers even in relation to simple schemes would benefit by those advisers having ready access to additional and more detailed information.

Supplementary/replacement disclosure

Most disclosure documents can be corrected or updated by a supplementary or replacement document. However, the Supplementary PDS regime is not available for shorter PDSs, on the basis that it is easier to issue a new PDS than prepare a supplementary document.[855] Another reason for not permitting supplementary disclosure documents is that they can make disclosure more difficult to understand and increase the risk of important information being overlooked.

Life of disclosure document

Another key difference between the prospectus and PDS regimes concerns the life of the documents. The expiry date of a prospectus must not be later than 13 months after the date of the prospectus.[856] By contrast, there is no limit on the time a PDS can remain current (though information in a PDS must be up to date when it is given,[857] where necessary through the giving of a supplementary PDS[858]).[859]

10.4.5 Requirements for scheme constitutions

Matters covered by a scheme constitution include the respective rights of the RE and the scheme members. A scheme constitution, as well as being a source of rights for members, provides them with important information about those rights.

As discussed in Section 5.2.2, the constitution must contain information about the consideration to be paid to acquire an interest in the scheme, the powers of the RE to deal with scheme property, the method for dealing with complaints by scheme members, and the winding up of the scheme.[860] Various other rights or powers, including the right of the RE to be paid for operating the scheme and the power for the RE to borrow or raise money, can only be exercised if included in the scheme constitution.[861]

However, the scheme constitution is primarily a governance document. Section 10.7.1 discusses the extent to which matters that are currently dealt with in the constitution should be:

- contained in a disclosure document (whether a PDS, as at present, or a prospectus, if disclosure for schemes is more closely aligned with that for companies) instead of the scheme constitution, or alternatively

- conveyed to investors by providing them with a copy of the constitution and/or by summarising those matters in the disclosure document.

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855 Commentary on Corp Reg 7.9.11U in the Explanatory Statement to *Corporations Amendment Regulations 2010 (No. 5)*.
856 s 711(6). This document life also applies to a profile statement (s 714(2)).
857 s 1012J.
858 s 1014D.
859 Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 14.107.
860 s 601GA(1). Regulatory Guide 134 *Managed investments: Constitutions* (February 2014) gives ASIC's view on what is necessary to comply with ss 601GA and 601GB.
861 s 601GA(2)-(4).

10.4.6 Specific initial disclosure items

There is a question whether there is any need to:

- add to the list of specific matters that must be disclosed to prospective investors in schemes, or
- modify any of the current items.

This issue would arise if PDSs, with their directed disclosure approach involving a list of specific matters to be disclosed, continue to be the initial disclosure document for schemes. However, if schemes disclosure is more closely aligned with companies disclosure, some additional disclosure items might also be specified, in the same way as the current general disclosure requirement for prospectuses is supplemented by a requirement to disclose certain specific categories of information.[862]

Potential additional, or amended, disclosure items, as explained below, include:

- powers of investors
- the identification of scheme property and the nature of investor rights with respect to that property
- the nature and extent of the RE's indemnity from scheme assets
- the powers of the RE
- the level of anticipated borrowings by the RE
- any security that is provided in connection with those borrowings
- the priority between that security and investor interests
- the risk management system adopted by the RE for the scheme
- fee and cost disclosure.[863]

CAMAC notes the recommendation of the PJC Trio report that the Government release a consultation paper to investigate the best mechanism for an RE of a registered scheme to disclose its scheme assets at the asset level, to give scheme members the legal right to require specific information on the portfolio holdings of the registered schemes in which they have invested.[864]

Powers of investors

Prospective investors could be made aware that, as scheme members, they would have power at a general meeting of members to replace the RE,[865] to alter the scheme

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862 As discussed in Section 10.4.2 of this paper, these categories are the terms and conditions of the offer, fees and other payments to key parties involved in the offer and statements about three matters, being the quotation of the securities offered (if applicable), the time limit for issuing them and lodgement of the prospectus with ASIC.

863 Other possible disclosure items are discussed in Section 14.2 of this paper, which discusses whether certain IOSCO principles should be adopted into Australian law. Also, Section 12.3 raises a possible disclosure issue in relation to disclaimer of leases by the liquidator of a lessor RE.

864 *Inquiry into the collapse of Trio Capital* (May 2012), p xxiv, paras 7.49-7.56, 9.24-9.25, rec 9.

865 s 601FM.

constitution,[866] to approve various related party financial benefits[867] and to direct that the scheme be wound up.[868]

Given that investors in companies have similar or analogous powers, there may be a question why this specific disclosure requirement should apply to schemes and not to companies.

Scheme property

Investors should be aware of what constitutes scheme property and the nature of the rights that they have as investors with respect to that property. The definition of 'scheme property' is discussed in Section 3.3 of this paper.

The structural differences between schemes and companies would justify requiring this disclosure for schemes, but not for companies, under the current law. If the SLE Proposal is adopted, scheme property would no longer be held on trust for scheme members, who would hold residual rights to that property in the event that the scheme is wound up. The position of scheme members under the SLE Proposal would therefore be similar to that of shareholders and there would be no need for this additional disclosure item.

The RE's indemnity from scheme assets

Given the structure of schemes and the role that the RE's indemnity from scheme assets plays in the way a scheme operates, it may be considered important for prospective investors to have clear information about the nature and extent of that indemnity. There is no equivalent of the RE's indemnity for companies. The content of this possible disclosure item would change if the SLE Proposal were adopted. Creditors would have rights directly against scheme property: they would no longer have to rely on subrogation to the RE's indemnity rights or recovery from the RE, which would then rely on those indemnity rights. The indemnity rights of the RE under the SLE Proposal would be limited to its remuneration and expenses for acting as manager and agent.

Powers of the RE and the level of borrowings

Possible additional disclosure items may include the RE's power to borrow money (or the equivalent power of the MIS if the SLE Proposal is adopted), any limitations on such a power and the power to grant security for the purposes of the scheme.

Information about the potential impact that the obtaining of debt finance might have on the value of interests in a scheme may enhance the ability of investors to assess the level of risk associated with their investment.

Other disclosure items that may serve this purpose could include:

- the level of anticipated borrowings by the RE (or by the MIS if the SLE Proposal is adopted)
- any security that is provided in connection with those borrowings. In determining whether this disclosure item is necessary, it would be relevant to consider whether sufficient information is already contained in the various registers that record interests

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866 s 601GC(1)(a).
867 The related party provisions in Chapter 2E of the Corporations Act are applied, with modifications, to schemes by s 601LA. See Part 5C.7.
868 s 601NB.

in State and Territory real property and the Personal Property Securities Register (PPSR),[869] together with various Corporations Act disclosure requirements. For instance, the PPSR has provision for indicating when a security interest is granted by an entity as an RE of a registered scheme or as a trustee, so anyone searching the PPSR can see that the RE has granted the security interest as RE of the particular scheme.[870] An argument for having a specific disclosure item rather than relying on these registers is that, for various reasons, including that searches of these registers involve the payment of a fee, most retail clients are unlikely to conduct such searches in making investment decisions[871]

- the priority between that security and investor interests.

Some of the problems that have arisen in relation to schemes have arisen from unfounded expectations or misunderstandings about these matters on the part of investors. For instance, some agribusiness schemes borrowed to finance their operations and gave security over scheme property, such as the trees. Investors who were under the impression that their investment in the schemes would give them title to the trees found that secured lenders took priority over them when the schemes were wound up.

A similar disclosure item would not be necessary for companies. The RE (or the MIS if the SLE Proposal is adopted) only has the powers specifically conferred on it, typically by the scheme's constitution.[872] By contrast, a company has the legal capacity and powers of an individual.[873]

Risk management system used by the RE in the conduct of the scheme

It may be beneficial for investors to have information about the risk management system that the RE uses in the conduct of the scheme. There is currently no requirement for Product Disclosure Statements to contain this information.

Fee and cost disclosure

There are detailed requirements for the information that Product Disclosure Statements must include in relation to fees and costs.[874] The provisions leave open the possibility that some fees or costs will not be covered by the requirements and therefore not have to be disclosed. For instance, there is a detailed definition of 'management costs',[875] which may not cover all matters that constitute a cost to the acquirer of an interest in a scheme.

An alternative approach is to have a general disclosure item that covers all fees and costs involved in a scheme, for instance disclosure of any amount by which any net payment to members is likely to be reduced because of any cost relating to investment or administration in relation to the scheme. A requirement along these lines might cover such matters as costs that are incorporated in the price of a financial product or asset (such as the costs implicit in a swap agreement).

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869 The PPSR was established under the *Personal Property Securities Act 2009* (PPSA): Chapter 5 of the *Personal Property Securities Act 2009*.

870 *Personal Property Securities Regulations 2010* Schedule 1, Items 1.3, 1.5.

871 For the PPSR, see *Personal Property Securities Act 2009* s 190, *Personal Property Securities (Fees) Determination 2011* Section 4, Items 9-15.

872 The role of the constitution as a vehicle for initial disclosure is discussed in Section 10.4.5.

873 s 124.

874 s 1013D(4)(c), Corp Regs 7.9.16L, Schedule 10 Part 2. There is an exception in the case of a PDS for a simple managed investment scheme to which Corp Regs Part 7.9 Div 4 Subdiv 4.2C applies.

875 Corporations Regulations Schedule 10 Item 102.

The purchase of shares in a company does not involve the same ongoing management costs as for a scheme. There may therefore not be the need for companies to have the same level of fee and cost disclosure as schemes.

If the SLE proposal were adopted, disclosure of the services to be provided by the RE as manager and the fees paid for such services would still be necessary.

Question 10.4.1. What is the appropriate disclosure standard for the issue of interests in managed investment schemes? Should that standard vary depending on the type of scheme (including a simple managed investment scheme), the type of investor in the scheme, the amount invested in the scheme or some other factor (and, if the latter, what)?

Question 10.4.2. Are there any reasons why prospectuses (including a due diligence requirement) should not be required for the issue of interests in managed investment schemes?

Question 10.4.3. What disclosure requirements should there be for indirect acquisitions of securities pursuant to a custodial arrangement?

Question 10.4.4. To what extent is it desirable and possible to devise disclosure documents that allow comparability between various financial products?

Question 10.4.5. How might shorter disclosure documents best be achieved?

Question 10.4.6. Where shorter disclosure documents are permissible, should they:

- be in addition to the full disclosure document
- be an alternative to the full disclosure document?

Question 10.4.7. Alternatively, should any existing disclosure requirements be replaced with shorter disclosure requirements and, if so, what requirements should be replaced and with what?

Question 10.4.8. Should 'incorporation by reference' be permitted and, if so, in what form? In particular, what documents should be allowed to be incorporated?

Question 10.4.9. What rules should there be for supplementary disclosure documents?

Question 10.4.10. What is the appropriate life for a disclosure document relating to scheme interests?

Question 10.4.11. Should specific disclosure of any of the following items be required, and why:

- powers of investors
- what is scheme property and the nature of investor rights with respect to that property
- the nature and extent of the RE's indemnity from scheme assets
- the powers of the RE
- the level of anticipated borrowings by the RE
- any security that is provided in connection with those borrowings
- the priority between that security and investor interests
- the risk management system used by the RE in the conduct of the scheme
- fees and costs
- any other matters?

Would these items be covered by a general prospectus disclosure requirement?

10.5 Continuous disclosure and significant event reporting

The continuous disclosure requirements are the same for shares in a company and interests in a scheme where the shares or interests are ED securities[876] and the entities to which those securities relate are disclosing entities.[877] In that case, the relevant companies and schemes are subject to the continuous disclosure requirements in Chapter 6CA of the Corporations Act.

Listed disclosing entities must notify their market operator of continuous disclosure information if the listing market's rules so require.[878] In the case of the ASX, this notification must occur 'immediately'.[879] Where the listed disclosing entity 'is an undertaking to which interests in a registered scheme relate', the RE has this disclosure obligation.[880] The legislation states that this notification is 'for the purpose of the operator making that information available to participants in the market'.[881] A continuous disclosure notice lodged with the operator of an exchange market is accessible through the exchange website.

A disclosing entity that is not listed, or that is listed but whose listing market rules do not require continuous disclosure, must lodge its continuous disclosure notices with ASIC as soon as practicable[882] (but see Section 10.7.2 for a discussion of the circumstances in which ASIC will allow website disclosure as an alternative to lodgement). As with listed disclosing entities, the RE has the disclosure obligation where a registered scheme is involved.[883] A continuous disclosure notice lodged with ASIC is accessible by searching ASIC's database and obtaining a copy of the notice.

There is also a requirement for ongoing disclosure of material changes and significant events for scheme interests that are not ED securities.[884] This disclosure must take place 30 days before the change takes effect if it concerns fees or, in any other case, as soon as practicable, but not more than three months after the change or event.[885]

Question 10.5.1. Are any changes needed to the application of the continuous disclosure obligations to interests in managed investment schemes that are ED securities and, if so, what?

Question 10.5.2. Are any changes needed to the application of the material changes and significant events disclosure requirements to interests in managed investment schemes that are not ED securities and, if so, what?

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876 The expression 'ED securities' is short for 'enhanced disclosure securities' (s 111AD(1)) and denotes securities that are subject to the continuous disclosure requirements in Chapter 6CA of the Corporations Act.

877 s 111AC. The ALRC/CASAC report recommended (at para 5.35) that the continuous disclosure requirements apply to listed and unlisted schemes.

878 s 674.

879 ASX Listing Rule 3.1.

880 s 674(3). In some cases, the RE as well as the scheme of which it is RE may be a disclosing entity.

881 ibid.

882 s 675.

883 s 675(3).

884 s 1017B. The Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* gave the following rationale for applying the continuous disclosure requirements, rather than the material changes and significant events disclosure requirements, to schemes involving ED securities (para 14.134):

> This was done on the basis that the continuous disclosure provisions were better able to address ongoing disclosure obligations in relation to listed managed investments and having regard to the fact that the rules of financial markets would impose continuous disclosure obligations for such products in any case.

885 s 1017B(5).

10.6 Periodic disclosure

The RE of a scheme must give a member who acquired an interest in the scheme a periodic statement at least once a year.[886] The periodic statement must contain information that holders of those interests need to understand their investment, including, where relevant:

- opening and closing balances for the reporting period
- the termination value of the investment at the end of the reporting period (to the extent to which it is reasonably practicable to calculate that value)
- details of transactions in relation to the product during the reporting period
- any increases in contributions by the holder or another person during the reporting period
- return on investment during the reporting period (on an individual basis if reasonably practicable)
- details of any change in circumstances affecting the investment that has not been notified since the previous periodic statement.

ASIC has given class order relief to assist issuers of interests in registered schemes that are quoted AQUA products or quoted ED securities to prepare compliant periodic statements, in particular by:

- taking account of the fact that issuers may not know the price at which interests have been traded
- requiring reporting on an aggregated basis where the interests are stapled with another financial product.[887]

In addition to this periodic reporting requirement, registered schemes, like companies, must each year make available to their members a financial report, a directors' report and an auditor's report or a concise version of those reports.[888] If a scheme is also a disclosing entity, it must lodge with ASIC a half–year financial report.[889]

Question 10.6.1. Are any changes needed to the periodic disclosure obligations for interests in managed investment schemes and, if so, what?

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886 s 1017D. This obligation applies to all financial products that have an investment component, including managed investment schemes. It applies to an 'issuer', which, in the case of schemes, would be the RE: see footnote 778. The periodic statement need not be given if the issuer has already given the holder all the information that would be included in the periodic statement if it were to be given (s 1017D(7)).

887 ASIC Class Order [CO 13/1200]. The AQUA market was created by the ASX for the quotation and trading of interests in unlisted managed funds (as well as exchange traded funds (ETFs) and structured products): ASIC Regulatory Guide 198 (RG 198) *Unlisted disclosing entities: Continuous disclosure obligations* at 17, ASIC Consultation Paper 196 *Periodic statements for quoted and listed managed investment products and relief for AQUA products* (December 2012) para 4. See also ASIC Report 282 *Regulation of exchange traded funds.*

888 s 314. This requirement applies to registered schemes, as well as disclosing entities and companies. The only unregistered schemes that are subject to this requirement are certain recognised New Zealand schemes that are disclosing entities (see Section 14.1).

889 s 302.

10.7 Means of disclosure

10.7.1 PDS and constitution as vehicles for initial disclosure

As outlined in this chapter, the Product Disclosure Statement[890] and the scheme constitution both contain information of relevance to investors. However, the PDS is the primary means of conveying information to prospective investors about a financial product so that consumers have 'sufficient information to make informed decisions in relation to the acquisition of financial products, including the ability to compare a range of products'.[891] As discussed in Section 5.2.2, the scheme constitution is primarily a governance document.

Given this functional division between the PDS (as an initial disclosure document) and the scheme constitution (as primarily a governance document), it is necessary to assess:

- whether any of the matters currently contained in the scheme constitution might be better treated as items to be contained in a disclosure document
- whether any matters to be covered in a scheme constitution should also be disclosed in a disclosure document.

Inclusion in disclosure document only

There is an issue whether the current requirement that scheme constitutions make adequate provision for the consideration that is to be paid to acquire an interest in the scheme[892] may be better dealt with as a matter of disclosure in the PDS. An argument for continuing to require that the scheme constitution deal with this matter is that scheme members should not run the risk of being diluted by new members who acquire their interests at a lower price without a change to the scheme's constitution. An argument for requiring disclosure only is that this approach would allow for more flexibility in the pricing mechanism. The PDS could inform investors that the price of interests in the scheme may be determined by the RE from time to time (ASIC has given relief to enable REs to exercise this discretion[893]). Investors could then choose whether or not to acquire interests in the scheme on that basis. This type of question does not arise in the case of companies since the abolition of par value for shares in 1998.[894]

Inclusion in disclosure document as well as scheme constitution

Some of the possible additional disclosure items discussed in Section 10.4.6 (powers of investors, what is scheme property and the nature of investor rights with respect to that property, the nature and extent of the RE's indemnity from scheme assets and the powers for the RE) relate to governance and would be included in the scheme constitution.

An issue in relation to these, and other matters that are contained in the scheme constitution, is whether they should also be summarised in the PDS. On one view, governance matters may be relevant to a prospective investor in deciding whether to participate in a scheme and should therefore be disclosed in the PDS. This view may

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890 For convenience, the discussion in this section refers to the PDS as the initial disclosure document. The same considerations would apply if prospectuses were restored as the vehicles for initial disclosure in relation to schemes.

891 Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 14.18.

892 s 601GA(1)(a).

893 ASIC Class Orders [CO 05/26] and [CO 13/655].

894 By the *Company Law Review Act 1998*, which came into effect on 1 July 1998.

particularly apply in the case of those schemes that operate in a similar way to companies, involving a greater degree of investor engagement, rather than merely as passive investment vehicles. On the other hand, in certain cases, the inclusion of mandatory additional disclosure of matters that investors do not appreciate to be important could lead to investors ignoring or failing to understand key information in the PDS.

A further issue is whether investors should be able to obtain, free of charge, a copy of the scheme constitution, regardless of whether the PDS summarises its main features.

10.7.2 Methods for making required disclosures

Current position

Corporations legislation

The Corporations Act and Regulations provide for various means for making the different types of required disclosure in relation to interests in schemes. The relevant disclosure document can be:

- given to the person[895] or the person's agent[896]
- sent to the person,[897] or the person's agent,[898] at an address (including an electronic address)[899] or fax number nominated by the person or the agent
- made available in a way that is agreed with the person[900] or the person's agent.[901] This method allows for the statement to be provided in electronic form but, if it is provided in this form, it must be presented in a way that 'will allow the person to whom it is given to keep a copy of it so that the person can have ready access to it in the future' and that 'clearly identifies the information that is part of the statement'.[902]

By contrast, with shares in companies, an offer of securities for which a prospectus is being used must be made in, or accompanied by, the prospectus, but there is no stipulation

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895 ss 1015C(1)(a)(i) (PDSs), 1017B (material changes and significant events notification: this notification may be given to the holder of an interest in a managed investment scheme in writing or electronically: s 1017B(3)(a), (b)), 1017D (periodic statements). The PDS provisions relating to the methods for making required disclosures also apply to Short-Form PDSs and shorter PDSs for simple managed investment schemes.

896 s 1015C(1)(a)(i), (3) (PDSs).

897 s 1015C(1)(a)(ii) (PDSs).

898 s 1015C(1)(a)(ii), (3) (PDSs).

899 s 1015C(2) (PDSs).

900 Corp Regs 7.9.02A(1)(a) (PDSs), 7.9.75A(1)(a) (material changes and significant events notification), 7.9.75A(2)(a) (periodic statements). In the case of a PDS, the person obliged to give the statement must be satisfied, on reasonable grounds, that the recipient has received the Statement.

901 Corp Regs 7.9.02A(1)(b) (PDSs), 7.9.75A(1)(b) (material changes and significant events notification), 7.9.75A(2)(b) (periodic statements). In the case of a PDS, the person obliged to give the statement must be satisfied, on reasonable grounds, that the recipient has received the Statement.

902 Corp Regs 7.9.02B (PDSs), 7.9.75B (material changes and significant events notification and periodic statements). For disclosure in electronic form, see also s 1015C(1)(b) (PDSs), s 1017D(6) (periodic statements). ASIC regards ease of access to electronic documents as a principle of good practice governance: Regulatory Guide 107 *Fundraising: Facilitating electronic offers of securities* (March 2014) Principles 1 and 7 (Table 1 and RG 107.76-RG 107.79, RG 107.98-RG 107.101). See also RG 107.30.

of how the prospectus is to be given to the person to whom the offer is made. However, ASIC interprets the legislation as allowing the giving of a prospectus in electronic form.[903]

The continuous disclosure requirements apply equally to companies and schemes whose securities are ED securities. As mentioned in Section 10.5:

- a continuous disclosure notice lodged with the operator of an exchange market is accessible through the exchange website
- a continuous disclosure notice lodged with ASIC is accessible by searching ASIC's database and obtaining a copy of the notice.

ASIC

ASIC has facilitated the use of websites for continuous disclosure by unlisted disclosing entities in Regulatory Guide 198 (RG 198) *Unlisted disclosing entities: Continuous disclosure obligations* (2009).

RG 198 recognises that publication on a website or in some other format does not relieve an unlisted disclosing entity from its obligation to lodge a continuous disclosure notice with ASIC.[904] However, ASIC will not insist that an unlisted disclosing entity comply with the legislative requirement to lodge continuous disclosure notices with ASIC if the disclosing entity satisfies certain conditions,[905] namely that it:

- is satisfied that most of its investors are likely to look for information of this kind on its website[906]
- notifies existing and new investors that it makes disclosure available in this way[907]
- discloses any material information on its website in a timely fashion[908] in accordance with the good practice guidance set out in RG 198 (and regardless of whether it has also disclosed the information in some other public document, such as a new or

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903 RG 107.7, RG 107.16. Consultation Paper 211 *Facilitating electronic offers of securities: Update to RG 107* (June 2013) (CP 211), noted (at para 15) that 'there is no requirement in Ch 6D for a disclosure document or application form used for an offer of securities to be in a prescribed form'. ASIC therefore concluded (at para 16) that 'there is no requirement in Ch 6D for a disclosure document to be printed and provided on paper only' and 'the Ch 6D requirements may be satisfied by the distribution, using the internet or other electronic means, of a disclosure document to investors that is the same as the paper disclosure document lodged with ASIC'. See also Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* para 8.59.

904 RG 198.11, RG 198.37. While the continuous disclosure obligation does not apply to information that is 'generally available', publication on a website does not bring information within this category: information will only be 'generally available' if it 'was generally available at the time the entity became aware of it': RG 198.37.

905 RG 198.13.

906 If an entity routinely sends written information by post to most of its investors (for instance, because they are elderly and do not use Internet communications), it cannot take advantage of the approach in RG 198: note to RG 198.13(a).

907 In fact, RG 198 states ASIC's view that unlisted disclosing entities should notify their existing and new investors, by normal investor communication channels such as their website or a regular investor update, how they intend to comply with the continuous disclosure regime (that is, whether they will follow ASIC's good practice guidance or simply lodge continuous disclosure notices with ASIC): see RG 198.14, RG 198.42-RG 198.44. Also, since 30 September 2009, a prospectus or PDS issued by an unlisted disclosing entity should describe how it will comply with its continuous disclosure obligations: see RG 198.15, RG 198.44.

908 For the website as a timely and efficient means of disclosure, see also RG 198.22.

supplementary prospectus or PDS, a statutory report or accounts lodged with ASIC or an investor newsletter[909]).

In ASIC's view:

> website disclosure will often be the most effective means for unlisted disclosing entities to disclose new material information to their investors.[910]

Also:

> information that is prominently disclosed on a website in a timely way will generally be more accessible to investors than information that is lodged with [ASIC].[911]

Even where disclosing entities decide that their investors are unlikely to make use of website disclosure, ASIC encourages them to contact it to 'discuss whether there is an alternative to lodging information with ASIC that may be more effective for their investors'.[912]

The ASIC good practice guidance for website disclosure suggests that this disclosure have the following features:

- all material information is included on the website[913]
- investors are able to find material information easily and determine its significance for them[914] (the information should be located in a single place on the website and the homepage should contain a prominent link to this location[915])
- any new material information is included on the website as soon as practicable[916]
- information is kept on the website for as long as it is relevant, and appropriate records (for instance, hard copy or an electronic form such as a CD ROM) are kept.[917]

ASIC encourages unlisted disclosing entities to consider giving their investors the option of receiving an email alert when material information is updated on the website.[918]

In addition to making material information available on their website, unlisted disclosing entities should also consider whether direct disclosure of the information to investors is

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909 RG 198.16, RG 198.20, RG 198.24, RG 198.38, RG 198.41. This ASIC requirement is stricter than the requirement under the Corporations Act, which exempts unlisted disclosing entities from having to include in their continuous disclosure notices information required to be included in a supplementary or replacement prospectus or information included in a PDS, Supplementary PDS or Replacement PDS (s 675(2)(c)).

910 RG 198.2. See also RG 198.11.

911 RG 198.40.

912 RG 198.19.

913 RG 198.21, RG 198.22.

914 RG 198.21. ASIC discourages the publication of lengthy documents in which the material information is buried among information that is not material: RG 198.25. If an unlisted disclosing entity considers that an investor may have difficulty readily identifying material information, it should consider separately highlighting that information to investors: RG 198.26.

915 RG 198.23.

916 RG 198.21, RG 198.29-RG 198.31. The timing of the obligation to lodge continuous disclosure information as soon as practicable is not affected by the fact that the information also needs to be included in a document required under another section of the Corporations Act. For instance, if an entity becomes aware of material information while preparing a prospectus, it will need to lodge that information with ASIC as soon as practicable, even if the prospectus is incomplete: RG 198.39.

917 RG 198.21, RG 198.32-RG 198.33.

918 RG 198.28.

appropriate (for instance, where the entity is aware that a significant number of investors might not have ready access to the Internet).[919]

Possible reform

Disclosure of information could be enhanced by taking advantage of developments in technology for PDSs, periodic statements and continuous disclosure notices. This approach would reflect a growing trend to website disclosure. In addition to ASIC's approach in RG 198, the proposed third edition of the ASX Corporate Governance Council *Corporate Governance Principles and Recommendations* provides for disclosure on a company's website as an alternative to disclosure in its annual report.[920]

However, CAMAC is reluctant to specify a particular form of electronic or other technological disclosure (such as disclosure on a website), given the tendency for rapid technological change.

The best approach may be for the Corporations Act to contain a general requirement that disclosing entities provide information in a manner that makes it available to all existing and potential investors. If it would assist industry, ASIC could publish guidance from time to time about optimal ways to do this. Members might also be given an option to be alerted by email of any change to the PDS or continuous disclosure material.

Whether this additional disclosure obligation should replace or merely supplement the current disclosure requirements is a separate question. A single location for disclosure would avoid duplication and the possibility of accidental divergence in the timing of disclosure, with the attendant possibility of disadvantage to some investors. If any new form of disclosure supplements existing disclosure requirements, the various forms of disclosure could be required to draw attention to the availability of the other forms of disclosure.

Regardless of any use of technology to provide alternative methods for making disclosures, it may be desirable to retain a requirement for disclosure to be available in paper form as an alternative to any permitted forms of electronic disclosure.[921]

The issues relating to the methods for making disclosure apply equally to companies.

Question 10.7.1. Should any matters currently required to be included in the scheme constitution instead be disclosed in the PDS (or any document that replaces it) (for instance, the consideration to be paid to acquire an interest in the scheme)?

Question 10.7.2. Should any additional matters specified as requiring disclosure to investors in response to Question 10.4.11 be included in the scheme constitution as well as being disclosed in the PDS (or any document that replaces it) and why?

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919 RG 198.27.

920 See at 5, 6, 17, 21, 27, 30, 31, as well as the definition of 'disclose' in the glossary at 35. The CLERP 9 paper *Corporate disclosure: Strengthening the financial reporting framework* (2002) raised the possibility of listed entities being required to post materially price-sensitive information on their websites at the same time that this information is first released by the relevant market operator, as well as being required to provide facilities for investors to be electronically alerted through real time electronic messaging systems such as email or SMS (Section 8.5.4).

921 See the comments of ASIC in Regulatory Guide 107 *Fundraising: Facilitating electronic offers of securities* (March 2014) Table 1 Principles 5 and 6, RG 107.5, RG 107.31, RG 107.92-RG 107.97.

Question 10.7.3. Should prospective investors be given a copy of the scheme constitution and/or should there be an express obligation for the PDS (or any document that replaces it) to summarise the key features of the constitution?
Question 10.7.4. Should greater use of technology be permitted for satisfying the various disclosure requirements and, if so, in what way?

Question 10.7.5. Should any amendments permitting greater use of technology replace, or merely supplement, the current disclosure requirements?

11 Takeovers and reorganizations of schemes

This chapter discusses whether there should be statutory provisions governing the takeover of unlisted schemes or the reorganization of schemes.

11.1 Scheme takeovers

The issue

Is there any need to change the takeovers provisions for managed investment schemes, for instance to extend them to unlisted schemes having more than a certain number of members (large unlisted schemes)?

Current position

Control of the management of a scheme is exercised by the RE of the scheme, in a manner analogous to the control of a company by its board of directors.

A change of RE can only occur with the agreement of the scheme's members[922] or, in limited circumstances, with ASIC relief (a condition of which, however, is that scheme members have the opportunity to vote on the change).[923] The relevant members' resolution need only be an ordinary resolution if the scheme is listed, but must be an extraordinary resolution (requiring at least 50% of the total votes that can be cast by members entitled to vote, whether or not cast) if the scheme is unlisted.[924] The RE and its associates are entitled to vote on the resolution if the scheme is listed, but not if it is unlisted.[925]

A change of RE with the agreement of a sufficient majority of scheme members can take place through a contested takeover of the scheme, where the bidder seeks to acquire sufficient voting interests in the scheme to enable it to pass a resolution at a meeting of members to remove the current RE.

The takeovers provisions in Chapter 6 of the Corporations Act apply to the acquisition of interests in listed managed investment schemes, so that takeovers of listed schemes are

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922 When the RE retires, it must call a meeting of members to choose a new RE (s 601FL).
The members may also remove an RE and appoint a new RE (s 601FM). CAMAC has recommended that provisions concerning the continuation of a particular party as the RE of a scheme, or approval of a replacement RE, should be enforceable only if they do not unreasonably inhibit the right of scheme members to replace the RE (2012 CAMAC Report Section 5.3.3).

923 ASIC has granted relief to permit a change of RE without a meeting, for instance where the existing RE was to be replaced with a related body corporate (ASIC Report 34, *Overview of decisions on relief applications from financial service providers (October 2003 to August 2004)*, para 4.22).
The standard relief typically requires that:
- members entitled to vote on the proposal who together hold at least 5% of the total value of the interests held by members, or
- at least 100 members entitled to vote on the proposal

be given the right to seek a vote on the change of RE. Such a vote is taken either by post or by the convening of a meeting.

924 ss 601FL, 601FM, definition of 'extraordinary resolution' in s 9. ASIC has provided relief to ensure that members of a listed registered scheme can request or call a meeting to consider and vote on an ordinary resolution to change the RE: see ASIC Regulatory Guide 9 *Takeover bids* at RG 9.570-9.574, Class Order [CO 13/519]. This ASIC relief overcomes a technical deficiency in the Corporations Act.

925 s 253E. In Section 8.4 of this paper, CAMAC raises the question whether the voting exclusion should apply regardless of whether the scheme is listed or unlisted.

regulated in the same way as takeovers of listed companies or companies with more than 50 members. Chapter 6 applies to a listed scheme as if:

- the scheme were a listed company
- interests in the scheme were shares in the company
- voting interests in the scheme were voting shares in the company
- a meeting of the members of the scheme were a general meeting of the company
- the obligations and powers that are imposed or conferred on the company were imposed or conferred on the RE
- the directors of the RE were the directors of the company
- the appointment of an RE for the scheme were the election of a director of the company
- the scheme's constitution were the company's constitution.[926]

Similarly, the compulsory acquisition provisions in Chapter 6A of the Corporations Act extend to the acquisition of interests in a listed scheme as if:

- the scheme were a company
- interests in the scheme were shares in the company
- voting interests in the scheme were voting shares in the company.[927]

Chapters 6 and 6A do not regulate the acquisition of interests in an unlisted scheme.

The application of Chapters 6 and 6A to listed schemes results in the application of the ancillary provisions in Chapter 6B. The substantial holding provisions in Part 6C.1 and the provisions for tracing beneficial ownership in Part 6C.2 also apply to listed registered schemes.

A change of control of a scheme may also in effect take place through a change of control of the RE, which may occur:

- by agreement between the person seeking control of management of the scheme (the bidder) and the shareholders and directors of the RE
- through a takeover of the RE by the bidder without the support of the directors of the RE.

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926 s 604. See also s 12(3) for the application of the definition of 'associate' to the managed investment provisions and s 610(5) for voting power in a managed investment scheme.

927 s 660B. The compulsory acquisition provisions apply to an unlisted registered scheme that was listed at the end of a bid or at the time a compulsory acquisition notice is lodged (s 660B(2), (3)). ASIC relief may be required to adapt the compulsory acquisition provisions for managed investment schemes: see ASIC Regulatory Guide 10 *Compulsory acquisitions and buyouts* at RG 10.98.

The latter situation may not arise very frequently, given that many REs do not have a broad shareholding base. It may, however, arise in some contexts, for instance internally managed stapled schemes where the scheme members also hold the shares in the RE.

A variation on these situations would be where the RE is a subsidiary of which a bidder gains control through an agreed or hostile takeover of the parent company.

Unlike corporations, the members of the scheme have no role to play in a change of control of the RE unless they are also members of the RE.

Analysis and discussion

The takeover and compulsory acquisition provisions in Chapters 6, 6A and 6B of the Corporations Act were extended to the acquisition of interests in listed schemes by the *Corporate Law Economic Reform Program Act 1999*.[928] The reasons that the Explanatory Memorandum gave for extending the takeover provisions to listed schemes, but not to any unlisted schemes (regardless of size), were:

- the redemption facility of a listed scheme is suspended and units trade at a price set by the market. This provides an opportunity and an incentive for a bidder to pay a premium over the market price for control parcels of undervalued units

- by contrast, for most unlisted schemes the manager provides investors with a withdrawal facility at a price reflecting the net asset backing of the units. This would be a strong disincentive for a bidder, who must pay a premium for the units above the value for which they can be redeemed

- in the case of open-ended schemes, new interests are issued on a continuous basis as investments are made.[929] While the potential effect of this could be overcome by the imposition of 'freezes' on the issue of new interests when a takeover bid is launched, this would appear to amount to an unwarranted interference in the ordinary operation of the scheme.[930]

Other possible reasons for not extending the takeover provisions to listed schemes are:

- the value of control of the scheme may be seen as belonging to the RE that operates (and may also have established) the scheme

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928 For the law relating to scheme takeovers before Chapter 6 was extended to takeovers of listed managed investment schemes by the *Corporate Law Economic Reform Program Act 1999*, see HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [23.142].

929 For more detail about open-ended schemes and closed-end schemes, see P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶90-200.

930 Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999*, paras 7.47-7.49.
The ALRC/CASAC report recommended a comprehensive review of takeovers of managed investment schemes (para 11.30). The CLERP reforms followed on from policy work carried out by the Corporations Law Simplification Task Force and by the Financial System Inquiry that was established by the then Treasurer, the Hon Peter Costello MP, in 1996 (the Wallis Committee).
The Simplification Task Force paper *Takeovers: Proposal for simplification* (1996) pp 20-21 raised as an issue for consideration whether the Chapter 6 takeover rules should apply to listed schemes, with an ordinary resolution being sufficient to change the RE (Issue for consideration 27B). However, its primary proposal was that a change of RE be approved by an absolute majority (by value) of the disinterested members of the scheme, with both the RE to be removed and the proposed new RE (together with their associates) being precluded from voting (Proposal 27). The Task Force also raised as an issue whether there should be a lower approval threshold (Issue for consideration 27A).
The *Financial System Inquiry Final Report* (1997) (the Wallis report) recommended takeover provisions modelled on Chapter 6 of the Corporations Law for public unit trusts (rec 87).

- attempts to enable members to appropriate a control premium could prove futile, as the RE could use deferred management fees or long-term service contracts with related parties to make becoming the RE of the scheme unattractive (though this may constitute unacceptable conduct if unlisted schemes came within the jurisdiction of the Takeovers Panel).

An argument for extending the takeover provisions to unlisted schemes is that such provisions allow the market to work efficiently by providing a mechanism for removing bad management from larger entities that are experiencing difficulties.

Extension of the statutory takeover procedure to unlisted schemes would also enable a party who has acquired a substantial proportion of the interests in the scheme to compulsorily acquire the outstanding interests.[931] The economic and administrative benefits of compulsory acquisition include facilitating financial restructuring and reducing administrative and reporting costs.[932] A statutory procedure for compulsory acquisition may be particularly useful for illiquid unlisted schemes that do not have a withdrawal facility (either because they were designed that way or because the withdrawal facility has been suspended).

If it were decided to extend the takeover provisions to large unlisted schemes, consideration might be given to including in any takeover procedure applicable to those schemes a freeze on the issue of new interests on commencement of a takeover bid, notwithstanding the reservations expressed about such an approach when the current takeover provisions for listed schemes were introduced. However, this approach may impose undue pressure on a target scheme.

The difficulties for unlisted scheme takeovers go beyond the mere absence of a statutory takeover mechanism. The Corporations Act presents obstacles to parties who want to make a bid for an unlisted scheme. For instance, there is a prohibition on making unsolicited offers to purchase scheme interests off-market.[933]

Where the effective control of a scheme changes through a change of control of the RE, different considerations apply. On one view, it is not appropriate for the members of a scheme who are not also members of the RE to have any role in a change of control of the RE. Control of the RE should be a matter for members of the RE only. The members of the RE, but not the members of the scheme, would have an interest in any premium for control of the RE. Scheme members who are not satisfied with the new controllers of the RE can propose a resolution of members to replace the RE. Members may also choose to replace an RE for reasons unrelated to any change in control of the RE.

Question 11.1.1. Are the legislative procedures for the takeover of listed managed investment schemes appropriate? If not, what legislative amendments are needed?

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931 The current statutory compulsory acquisition threshold for listed companies, unlisted companies with more than 50 members and listed schemes is 90% by number of the securities in the bid class, provided that the bidder and its associates acquired at least 75% (by number) of the securities that the bidder offered to acquire under the bid (whether the acquisitions happened under the bid or otherwise): s 661A. Similarly, a bidder who has acquired at least 90% of the securities (by number) in the bid class at the end of the offer period must offer to buy out the remaining holders of bid class securities (s 662A).

932 CAMAC report, *Compulsory Acquisitions* (1996) para 1.11.

933 Part 7.9 Div 5A.

Question 11.1.2. Should there be takeover provisions for large unlisted schemes in all circumstances or in some circumstances and, if so, what (for instance, where a scheme is part of a larger commercial enterprise, other elements of which are being taken over)?
Question 11.1.3. If a takeover procedure for large unlisted schemes is adopted, what features should that procedure have (for instance, should there be a freeze on the issue of new interests when a takeover bid is launched)?

11.2 Reorganization of schemes

The issue

Should there be a statutory procedure for the reorganization of managed investment schemes?

Current position

A reorganization of a company may be achieved through a scheme of arrangement under Part 5.1 of the Corporations Act. A scheme may be between members and/or creditors of a company. The voluntary administration provisions in Part 5.3A of the Corporations Act can also be used in the reorganization of the affairs of an insolvent company.

Neither Part 5.1 nor Part 5.3A is available for managed investment schemes.[934]

One means of reorganizing schemes, whether solvent or insolvent, is by use of the scheme's constitution. This may be either with the agreement of members under the existing constitution or by amendment of the constitution by special resolution of members.[935] A scheme constitution can also be amended by the RE where the RE 'reasonably considers the change will not adversely affect members' rights'.[936] In that case, the RE is bound by a duty to 'treat the members who hold interests of the same class equally and members who hold interests of different classes fairly'.[937]

Another approach to the reorganization of managed investment schemes is the use of trust scheme arrangements. A scheme reorganization by amendment of the scheme's constitution can be carried out independently of, or in conjunction with, a trust scheme.[938]

Trust schemes rely on the court's inherent jurisdiction and the provisions of the State-based trust legislation and usually involve amendment of the scheme's constitution by special resolution of members.[939] A trust scheme is similar to a members' scheme of arrangement but, being a non-statutory procedure, does not involve the equivalent of the judicial and other procedural protections applicable to corporate schemes of arrangement under Part 5.1. However, the proponents of a trust scheme may choose to seek judicial

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934 The scheme of arrangement provisions only apply to a 'Part 5.1 body', defined under s 9 as meaning a company or a registrable body under Part 5B.2 of the Act. The voluntary administration provisions are only available for companies that are insolvent or likely to become insolvent (s 436A).
For the possibility of encompassing a scheme in the voluntary administration of its RE, see the 2012 CAMAC Report at Section 6.3.4.

935 s 601GC(1)(a).

936 s 601GC(1)(b).

937 s 601FC(1)(d).

938 The court has regularly given directions in relation to the reconstruction of insolvent schemes by constitutional amendment: see *Re Elders Forestry Management Ltd* [2012] VSC 287 at [6]-[7].

939 s 601GC.

direction or advice on its implementation, in which case the trust scheme may involve elements analogous to those applicable to schemes of arrangement.[940]

A trust scheme merger of two or more managed investment schemes may be:

- a redemption scheme, whereby all units, other than those held by the intending controller, are cancelled for a cash and/or other consideration,[941] or
- a transfer scheme, whereby all units are transferred to the intending controller for a cash and/or other consideration. Transfer schemes for listed managed schemes also require a resolution of unitholders to permit the intending controller to acquire more than 20% of the units.[942]

While there is no specific statutory procedure for trust schemes that involves an equivalent supervisory role for ASIC and the court that is inherent in a Part 5.1 scheme of arrangement, ASIC nonetheless performs a supervisory role in connection with its consideration of relief applications and associated meeting materials necessary to facilitate the trust scheme process for listed schemes.[943]

The Takeovers Panel has issued a Guidance Note that recommends various disclosure, voting and other procedures for trust schemes that involve listed trusts.[944] As is the case for members' schemes of arrangement, these procedures are similar to those in Chapter 6 of the Corporations Act.[945]

The reorganization of a commercial structure that consists of one or more trusts and one or more related companies can be dealt with through a combination of a trust scheme and a Part 5.1 scheme of arrangement.[946]

The court can use its winding up powers in relation to managed investment schemes[947] to give directions to achieve the reorganization of an insolvent scheme.

The reorganization of a scheme may also involve a buy-back of interests in the scheme. Buy-backs of scheme interests are discussed in Section 9.4 of this paper.

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940 For instance, in *Australand Holdings Limited* [2005] NSWSC 835, the trust scheme involved two approaches to the court for advice, similar to the first and second hearings that are involved in a corporate scheme of arrangement (see at [14]-[15], [28]). Also, in *Mirvac and Mirvac Funds* [1999] NSWSC 457, the trust scheme involved an explanatory statement that covered the trust scheme as well as the corporate scheme of arrangement (see at [21]). See also *Sydney Airport Holdings Limited as responsible entity of Sydney Airport Trust 2* [2013] NSWSC 1665 at [6], *Sydney Airport Holdings Limited as responsible entity of Sydney Airport Trust 2* [2013] NSWSC 2012 at [8].

941 Under a redemption scheme, the scheme redeeming interests can be delisted before any units in it are issued to the intending controller, to avoid a breach of the takeover provisions in Chapter 6 of the Corporations Act: see Takeovers Panel Guidance Note 15 *Trust scheme mergers* para 5(a).

942 Item 7 of s 611. Listed managed investment schemes are subject to the takeover provisions in Chapter 6 of the Corporations Act: s 604; see also Section 11.1 of this paper. A trust scheme merger relying on Item 7 of s 611 requires an ASIC modification or exemption as, under that Item, votes cannot be cast in favour by persons proposing to acquire or dispose of interests: see Takeovers Panel Guidance Note 15 *Trust scheme mergers* para 5(b).

943 ASIC Regulatory Guide 74 *Acquisitions approved by members*, Section D.

944 Takeovers Panel Guidance Note 15 *Trust scheme mergers*.

945 Takeovers Panel Guidance Note 15 *Trust scheme mergers* para 8, which refers to the policy that courts apply when considering s 411(17) in connection with a members' scheme of arrangement. See also ASIC Regulatory Guide 74 *Acquisitions approved by members* at RG 74.65.

946 See, for instance, *Mirvac and Mirvac Funds* [1999] NSWSC 457, *Australand Holdings Limited* [2005] NSWSC 835, *Abacus Funds Management Ltd* [2006] NSWSC 80.

947 ss 601ND, 601NF(2).

Analysis and discussion

None of the current methods for reorganizing solvent and insolvent schemes is completely satisfactory.

The viability of a scheme reorganization through the use of procedures in a scheme constitution depends on the specific terms of that constitution (though amendment of a scheme constitution may be used as the first step in a reorganization process).

Also, while it may be possible to reorganize a scheme through the use of a court-ordered trust scheme, the jurisprudence for applying this procedure to the reorganization of managed investment schemes is still in an early stage of development and does not provide a certain basis for scheme reorganizations.

Furthermore, the lack of available mechanisms for the reorganization of a failed scheme may result in the winding up of such a scheme, where a compromise is difficult to achieve and an application to the court is necessary to provide certainty.

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

Given this, in CAMAC's view, there should be an integrated holistic process for managed investment schemes along the lines of Part 5.1, with provision for disclosure to ASIC, and a right for ASIC to comment, and the involvement of the court. This reorganization procedure should be available to insolvent as well as solvent schemes. In the case of insolvent schemes, creditors would be involved in considering whether to approve the reorganization, as is currently the case with creditors' schemes of arrangement for companies.

Extension of the Part 5.1 scheme of arrangement provisions to managed investment schemes has been supported by several policy reviews, including the CAMAC report *Members' schemes of arrangement* (2009).[948] The 2009 CAMAC report considered that Part 5.1 should be available for listed and unlisted schemes. CAMAC maintains this view, given that Part 5.1 is available for listed and unlisted companies.

CAMAC also believes that there should also be a voluntary administration procedure for insolvent schemes, comparable to Part 5.3A for companies. The 2012 CAMAC report recommended a VA procedure for schemes.[949] It provided details of how such a procedure might be implemented if the SLE Proposal is, and if it is not, adopted. It also discussed various implementation issues that would arise in either case.

Question 11.2.1. Should the provisions governing schemes of arrangement in Part 5.1 of the Corporations Act be extended to, or adapted for, managed investment schemes? If so, what changes would need to be made to cater for the managed investment scheme structure?

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948 Sections 7.2 and 7.6.2. The *Financial System Inquiry Final Report* (1997) (the Wallis report) recommended streamlined merger and reconstruction provisions for collective investment schemes for public unit trusts (rec 87).

949 See Chapter 6 of that report.

12 External administration

This chapter discusses the ability of those conducting the winding up of a scheme to claim remuneration and expenses, as well as what external supervision there should be of a scheme winding up. It also examines issues relating to the disclaimer of leases by the liquidator of an RE, the position of external administrators of an RE and the notification requirement when a receiver is appointed to property of an RE.

12.1 Remuneration and expenses in the winding up of a scheme

The issue

Should the Corporations Act make provision for meeting remuneration and expenses in relation to the winding up of a scheme along the lines of the provisions applicable to companies?

Current position

The constitution of a registered scheme must make adequate provision for winding up the scheme.[950] There is no legislative guidance on what constitutes 'adequate provision', including whether the scheme constitution should provide for remuneration and expenses in relation to the winding up, including the remuneration of the person conducting the winding up.

The court may make directions about remuneration and expenses in the exercise of its power to make directions about how a registered scheme is to be wound up.[951]

There is no detailed legislative provision for remuneration and expenses in relation to the winding up of an insolvent scheme to supplement these broad provisions.

The basis for claiming remuneration and expenses in relation to the winding up of a scheme depends on who is administering the winding up of the scheme.

Winding up conducted by the RE

In the first instance, the responsibility for winding up a registered scheme belongs to the RE. The RE may initiate a winding up if it considers that the purpose of the scheme has been accomplished or cannot be accomplished.[952] Where the court or the members initiate the winding up, they do so by directing the RE to wind up the scheme.[953] Where the RE

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950 s 601GA(1)(d).

951 s 601NF(2), (3).

952 s 601NC. A scheme can also be wound up at a specified time or in specified circumstances or on the happening of a specified event where the scheme constitution so provides (s 601NA): the RE would be responsible for the winding up, though s 601NA does not stipulate that this is the case.

953 ss 601NB (members), 601ND (the court).
The court has the power to order the winding up of a scheme if it thinks it is just and equitable to do so or if there is unsatisfied execution or other court process (s 601ND). The 2012 CAMAC Report recommended that the court also have a power to order the winding up of a scheme where satisfied that the scheme is insolvent (Section 7.4.1). Such a power would make redundant the current unsatisfied execution ground, which could then be repealed.

remains in control of the scheme during the winding up process, it has a right to be indemnified out of scheme property for liabilities or expenses incurred in relation to the performance of its duties, if two conditions are satisfied:

- the right is specified in the scheme's constitution, and
- the RE has properly performed its duties.[954]

Winding up conducted by a person appointed by the court

The court has the power to appoint a person other than the RE to take responsibility for ensuring that a registered scheme is wound up in accordance with its constitution and any orders of the court (including for the reason that the RE has ceased to exist or is not properly discharging its obligations in relation to the winding up).[955]

When the court exercises this power (for instance, where the RE is insolvent or unable to continue in the role and a new RE has not been appointed), it can give directions that the person act as a receiver of the property of the scheme.[956]

The court order of appointment may provide for the receiver's right to be indemnified out of the scheme's assets for proper expenses and for remuneration (the order may also provide for the receiver's powers).[957] In the absence of appropriate provision in the court order, the receiver must rely on trust law to recover its remuneration and expenses, given that the RE holds scheme property on trust for scheme members.[958] Trust law principles on which a receiver might rely in seeking remuneration include:

- the equitable principle of salvage in *Re Universal Distributing Company Limited (In Liquidation)*[959] (which permits remuneration for work done in the care, preservation and realisation of scheme property to be charged against that property)
- the inherent power of the court to require an allowance to be made for costs that fall outside the salvage principle but are incurred for beneficial work done by an insolvency practitioner in relation to trust property (including scheme property).[960]

Winding up conducted by the liquidator of the RE

Where an RE and a scheme that it operates are both being wound up, the winding up of the scheme may be conducted by the liquidator of the RE.

The members of the scheme have the power by extraordinary resolution to direct the RE to wind up the scheme (s 601NB). An extraordinary resolution requires that it be passed by at least 50% of the total votes that may be cast by members entitled to vote on the resolution, whether or not cast (definition of 'extraordinary resolution' in s 9).

954 s 601GA(2). This right of indemnity is discussed in Section 7.2 of this paper.

955 s 601NF.

956 s 601NF(2). See *Re Equititrust Ltd* [2011] QSC 353 at [52], [54], [72]-[79]. The court also has the power to appoint a receiver under s 1101B where there has been a contravention of the financial services provisions in Chapter 7 of the Corporations Act: see *Re Equititrust Ltd* [2011] QSC 353 at [35], [76].

957 See, for instance, the Court's orders covering these matters in the orders annexed to the reasons in *Re Equititrust Ltd* [2011] QSC 353. The powers conferred by the Court were those set out in ss 420 and 1101B(8)(a)-(c).

958 s 601FC(2).

959 [1933] HCA 2; (1933) 48 CLR 171 at 174-175. The scope of the principle in that case was discussed in *Thackray v Gunns Plantations Limited* [2011] VSC 380 at [40]-[51].

960 *Thackray v Gunns Plantations Limited* [2011] VSC 380 at [52]-[58]. See also *Thackray v Gunns Plantations Ltd (No 2)* [2011] VSC 417. Other possible sources of power include s 511 (in the case of a voluntary liquidation) and the court rules (for instance, *Supreme Court (General Civil Procedure) Rules 2005* (Vic) r 54.02): *Re Gunns Plantations Limited (No 4)* [2013] VSC 595 at [2].

A claim for remuneration by the liquidator of the RE may:

- be derived from the RE's right of indemnity[961]
- be based on the salvage principle in *Re Universal Distributing Company Limited (In Liquidation)*[962]
- depend on the exercise by the court of its inherent jurisdiction.[963]

A claim by the liquidator of a company for remuneration is one of various types of specified claims that have priority over other unsecured debts in the liquidation of the company.[964] The right to claim remuneration is available for the performance of trust duties by a corporate trustee such as an RE.[965]

In determining the entitlement of the RE's liquidator to recover out of scheme property his or her remuneration and expenses in relation to the liquidation of the scheme, a distinction must be drawn between the liquidator's remuneration and expenses in:

- administering the scheme, and
- conducting the liquidation of the RE.[966]

The liquidator of an RE can only claim indemnity from scheme property (as distinct from the personal assets of the RE) for remuneration and expenses in relation to work that can be fairly categorized as administering the scheme.[967] This process may be relatively

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961 In *Re Suco Gold Pty Ltd* (1983) 33 SASR 99 at 110 (cited in *Re French Caledonia Travel Service Pty Ltd (in liq)* [2003] NSWSC 1008 at [202]), the Court said:

> It is part of the duty of the trustee company to incur debts for the purposes of the trust businesses and, of course, to pay those debts. Upon winding up those debts can only be paid in accordance with the provisions of the Companies Act. This requires necessarily that there be a liquidator and that he incur costs and expenses and be paid remuneration.

962 [1933] HCA 2; (1933) 48 CLR 171 at 174-175. This principle was cited as a possible ground for allowing the remuneration of the liquidator of a corporate trustee in *Re Suco Gold Pty Ltd* (1983) 33 SASR 99 at 110, *Re French Caledonia Travel Service Pty Ltd (in liq)* [2003] NSWSC 1008 at [202].

963 The Court in *Application of Sutherland* [2004] NSWSC 798 at [14] said that the cases in this area 'implicitly accept that the inherent jurisdiction of the Court to allow remuneration in connection with the administration of a trust fund is one which can apply so as to allow remuneration not only to a trustee, but also to someone who is for practical purposes controlling a trustee'.

964 s 556(1)(de), definition of 'deferred expenses' in s 556(2).

965 *Re Suco Gold Pty Ltd* (1983) 33 SASR 99 at 110, *Re French Caledonia Travel Service Pty Ltd (in liq)* [2003] NSWSC 1008 at [202]-[204].

966 *Bastion v Gideon Investments* [2000] NSWSC 939 at [69], *GB Nathan & Co Pty Ltd (In Liq)* (1991) 24 NSWLR 674 at 688.

967 *Re French Caledonia Travel Service Pty Ltd (in liq)* [2003] NSWSC 1008 at [194]-[217], *Re Application of Sutherland* [2004] NSWSC 798.

The type of activities covered were identified in the broader trust context in *13 Coromandel Place Pty Ltd v CL Custodians Pty Ltd (in liq)* [1999] FCA 144 at [34]:

> identifying or attempting to identify trust assets; recovering or attempting to recover trust assets; realising or attempting to realise trust assets; protecting or attempting to protect trust assets; distributing trust assets to the persons beneficially entitled to them.

See also *Bastion v Gideon Investments* [2000] NSWSC 939 at [69], *GB Nathan & Co Pty Ltd (in liq)* (1991) 24 NSWLR 674 at 688-689.

Given that the liquidator's rights derive from those of the RE, the right of indemnity must be specified in the scheme's constitution: s 601GA(2). The RE's right of indemnity is discussed in Section 7.2 of this paper.

straightforward for the liquidator of a sole-function RE.[968] However, for the liquidator of a multi-function RE:

> The liquidator is not entitled to charge the beneficiaries of one trust with the costs and expenses incurred in relation to the other trust. Accordingly, it will be necessary for the liquidator to estimate the costs and expenses incurred insofar as they relate to each trust and only charge those costs to the trust on whose behalf the work was performed. If that estimate is not possible then a pari passu distribution of the costs and expenses will be in order ... .[969]

It has been recognised that the distinction between remuneration and expenses that relate to a particular trust and other amounts claimable by a corporate trustee (including expenses incurred in relation to other trusts) is not always easy to draw.[970] The general expenses of liquidation include expenses that a liquidator incurs in performing his or her duty to identify the assets of the company for the purposes of the winding up. However, this duty involves ascertaining whether particular assets under the control of the company are beneficially owned by the company or by others: the liquidator cannot disregard the fact that the company holds property in trust for others.[971]

Analysis and discussion

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

The Corporations Act contains detailed provisions regarding the winding up of companies.[972] The 2012 CAMAC report recommended that the Corporations Act should regulate the winding up of an insolvent scheme in a manner comparable to the regulation of the winding up of an insolvent company.[973] It also contemplated that the winding up of insolvent registered schemes would be conducted only by a registered liquidator.[974]

The salvage principle and other general law rules governing entitlement to remuneration and expenses for work done in conducting a winding up may not provide persons charged with winding up a scheme with sufficient certainty about recovering these amounts and may make it difficult to find insolvency practitioners willing to accept appointment to a scheme. It may be preferable for the scheme winding up provisions to provide a clear right for the scheme liquidator to claim remuneration and expenses for its work in conducting the winding up.

In the winding up of a company, the following provisions give creditors an incentive to assist the liquidator to meet the expenses of winding up:

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968 *Bastion v Gideon Investments* [2000] NSWSC 939 at [70], *GB Nathan & Co Pty Ltd (in liq)* (1991) 24 NSWLR 674 at at 685-686, *Re French Caledonia Travel Service Pty Ltd (in liq)* [2003] NSWSC 1008 at [201], [205], *In Re Suco Gold Pty Ltd (in liquidation)* (1983) 33 SASR 99, *Grime Carter & Co Pty Ltd v Whytes Furniture (Dubbo) Pty Ltd* [1983] 1 NSWLR 158.

969 *13 Coromandel Place Pty Ltd v CL Custodians Pty Ltd (in liq)* [1999] FCA 144 at [37], *Re French Caledonia Travel Service Pty Ltd (in liq)* [2003] NSWSC 1008 at [213].

970 *Bastion v Gideon Investments* [2000] NSWSC 939 at [69], *GB Nathan & Co Pty Ltd (In Liq)* (1991) 24 NSWLR 674 at 688, *Re French Caledonia Travel Service Pty Ltd (in liq)* [2003] NSWSC 1008 at [209].

971 ibid.

972 Chapter 5 of the Corporations Act.

973 Section 7.5.3.

974 Sections 7.2.7, 7.3.2, 7.4.3. This is the case whether or not the SLE Proposal is adopted (see Section 7.3.2). For a discussion of whether the scheme winding up should be separate from, or combined with, the winding up of the scheme's RE if the RE is also insolvent, see the 2012 CAMAC report at Sections 7.3.1 and 7.4.2.

- a company liquidator is not liable to incur any expense in relation to the winding up of the company unless there is sufficient available property[975]
- the court or ASIC may direct a liquidator to incur an expense where a creditor is willing to indemnify the liquidator and, if necessary, give security for the expense[976]
- the court can make such orders as it deems just with respect to the distribution of property whose recovery, protection or preservation has been assisted by money contributed by particular creditors, with a view to giving those creditors an advantage over others in consideration of the risk assumed by them.[977]

Similar provisions may assist a person charged with winding up a registered scheme to conduct the winding up. If the recommendation in the 2012 CAMAC report were to be adopted, that person would be a registered liquidator if a scheme is insolvent. However, provisions along the lines of those designed to assist company liquidators may be appropriate regardless of who is in charge of the winding up, given that the initiative for their use would come from the creditor, rather than the person charged with the winding up.

Question 12.1.1. Should a scheme liquidator, or other person charged with the winding up of a registered scheme, be given a statutory right to claim remuneration and expenses of winding up the scheme and, if so, what form should it take?

Question 12.1.2. Should the Corporations Act provide that the liquidator of a registered scheme (or other person charged with the winding up of the scheme) is not liable to incur any expense in relation to the winding up of the scheme unless there is sufficient available property?

Question 12.1.3. Should the court or ASIC have a power to direct a liquidator of a registered scheme (or other person charged with the winding up of the scheme) to incur an expense where a creditor is willing to indemnify that person and, if necessary, give security for the expense?

Question 12.1.4. Should the court have a power to make such orders as it deems just with respect to the distribution of scheme property whose recovery, protection or preservation has been assisted by money contributed by particular creditors?

Question 12.1.5. What, if any, other provisions might assist a liquidator or other person charged with the winding up of a registered scheme in meeting the expenses of the winding up?

12.2 External supervision of a scheme winding up

The issue

An auditor of a registered managed investment scheme ceases to hold office when the scheme is wound up. This leaves no external supervision during a winding up by an RE.

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975 s 545(1).
976 s 545(2). This provision also applies where a shareholder is willing to indemnify the liquidator.
977 s 564.

Current position

An auditor of a registered scheme ceases to hold office if the scheme is to be wound up.[978]

This is similar to the situation for companies.[979] However, unlike company windings up, which are generally under the control of a registered liquidator, the winding up of a managed investment scheme is conducted by the RE.[980]

Analysis and discussion

The Turnbull Report recommended that further consideration be given to:

- repealing the current law terminating the appointment of an auditor so that an auditor's appointment would continue until the winding up is completed
- including a specific legislative requirement that the winding up process be audited.[981]

There needs to be some external supervision of the winding up of a scheme. However, any decision on whether the appointment of the auditor should continue during the winding up of a scheme needs to take into account existing potential sources of external supervision.

The insolvent winding up of a scheme is likely to be in the hands of a receiver. Also, where the RE of a scheme is insolvent as well as the scheme itself, the winding up of the scheme is likely to be in the hands of a liquidator. The 2012 CAMAC report recommended that all insolvent scheme windings up be conducted by a registered liquidator.[982]

Furthermore, the Corporations Act requires that a scheme constitution have adequate provisions about winding up the scheme.[983] ASIC considers that part of having adequate provision for winding up a scheme includes that the scheme constitution provide for an independent audit of the final accounts by a registered company auditor or audit firm after winding up.[984]

Question 12.2.1. Should there be external supervision of the winding up of a managed investment scheme and, if so, in what circumstances and by whom?

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978 This may be because prerequisites in the scheme's constitution that result in the winding up of the scheme are satisfied, the members or the court direct the RE to wind up the scheme or the members vote to remove the RE without appointing a new one at the same meeting (ss 331AD, 601NE(1)(d)).

979 s 330.

980 Turnbull Report Section 5.3.4.

981 ibid.

982 Sections 7.2.7, 7.3.2, 7.4.3. This is the case whether or not the SLE Proposal is adopted (see Section 7.3.2). For a discussion of whether the scheme winding up should be separate from, or combined with, the winding up of the scheme's RE if the RE is also insolvent, see the 2012 CAMAC report at Sections 7.3.1 and 7.4.2.

983 s 601GA(1)(d).

984 Regulatory Guide 134 *Managed investments: Constitutions* (February 2014) at RG 134.200-RG 134.203.
In the Consultation Paper that preceded the major revisions to RG 134, Consultation Paper 188 *Managed investments: Constitutions—Updates to RG 134* (September 2012) (CP 188), ASIC noted (at para 146) that there had been instances of scheme constitutions containing 'clauses that provide responsible entities with the discretion to arrange either an independent audit or a review of the final accounts of the managed investment scheme by a registered company auditor after winding up the scheme'. In ASIC's view (CP 188 at para 147):

> a review provides a lesser level of assurance of the final accounts of a managed investment scheme and only involves an auditor making inquiries (primarily of the persons responsible for financial and accounting matters) and applying analytical and other review procedures … a review has substantially less scope than an audit, and does not enable an auditor to obtain the same level of assurance that would be obtained under an audit - an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the accounts.

12.3 Disclaimer of leases

The issue

Is it appropriate for the liquidator of an RE that is a lessor of property to have a power to disclaim the lease?

Current position

As with any other company, where an RE goes into liquidation, the liquidator can disclaim any property held by the RE that falls within one of the specified categories of onerous property.[985] Property of a company includes a contract.[986] The High Court in *Willmott Growers Group Inc v Willmott Forests Limited (Receivers and Managers Appointed) (In Liquidation)* held, by majority, that a lease is a species of contract that can be disclaimed by a liquidator (whether of a lessor or of a lessee) and that the effect of disclaimer by a lessor company is to bring the lease to an end, including the interest of the lessee in the leased property.[987]

The liquidator of a lessor RE must notify the lessee of the disclaimer[988] and the lessee has the right to challenge the disclaimer, but must do so within 14 days of the notification being made.[989] The court may only set aside a disclaimer if satisfied that the disclaimer 'would cause, to persons who have, or claim to have, interests in the property, prejudice that is grossly out of proportion to the prejudice that setting aside the disclaimer would cause to the company's creditors'.[990]

The lessee, as 'a person aggrieved by the operation of a disclaimer', 'is taken to be a creditor of the company to the extent of any loss suffered by the person because of the disclaimer and may prove such a loss as a debt in the winding up'.[991]

Analysis and discussion

CAMAC notes that the law of disclaimer applies to the liquidation of companies generally and therefore has an effect outside the context of the winding up of an RE of a scheme.

Scheme members who have rights as lessees of property may have an expectation that their interests in the scheme are property interests that should have a favoured position in the winding up of a scheme, as do the interests of secured creditors. That expectation is not met under the present law where the lease can be disclaimed by a liquidator of the RE. To avoid disclaimer, member lessees would need to show that the prejudice to them is grossly out of proportion to the prejudice to the RE's creditors generally. This issue is particularly relevant for agricultural schemes, where leases of land and trees are often an integral part of the scheme structure.

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985 s 568.
986 s 568(1)(f).
987 [2013] HCA 51. The decision of the Court of Appeal in this litigation is discussed in O McCoy, 'Disclaimer by Liquidators: Divesting a Company of Continuing Obligations' (2013) 25(1) *Australian Insolvency Journal* 14 and K Bhindi, 'Disclaimer of contracts' 2013 13(9) *Insolvency Law Bulletin* 208. On the interpretation of the law adopted by the Court at first instance, the liquidator could disclaim the lease, but the effect of the disclaimer was very limited (O McCoy, 'Disclaimer by Liquidators: Divesting a Company of Continuing Obligations' (2013) 25(1) *Australian Insolvency Journal* 14 at 15).
988 s 568A.
989 s 568B.
990 s 568B(3).
991 s 568D(2).

CAMAC notes that the insolvency of the RE of a scheme that involves the RE leasing property to members of the scheme will not always result in disclaimer of the leases by the liquidator of the RE. A lease may be beneficial to the lessor by reason of the rent that it generates[992] or the liquidator may decide that long-term leases enhance the potential resale value of the scheme property.

If the current law remains, there is a question whether those who intend to become lessee investors should have the benefit of disclosure of the possible consequences of a liquidation of the scheme in relation to the interests that they intend to acquire in the scheme.

Question 12.3.1. Should the liquidator of an RE that is a lessor of property have the power to disclaim a lease of property under which scheme members are the lessees?

Question 12.3.2. If the liquidators of lessor REs continue to have the power to disclaim leases with member lessees, should those who intend to become lessee investors have the benefit of disclosure of the possible consequences of a liquidation of the RE in relation to the interests that they intend to acquire in the scheme?

12.4 Duties and obligations of officers of an RE in financial difficulties

The issue

Should external administrators be treated as officers of the RE?

Current position

'Officers' of an RE have various duties. They have the same duties as are owed by any officers of a company (for instance, the duties in ss 180-184 and their general law equivalents). In addition, they have duties under s 601FD that they owe specifically in the capacity of officer of an RE. These duties require that they:

- act honestly[993]
- exercise care and diligence[994]
- act in the best interests of the members and, if there is a conflict between the members' interests and the interests of the RE, give priority to the members' interests[995] (the 'best interests' duty)
- not misuse information or their position[996]
- take reasonable steps to ensure that the RE complies with the Corporations Act, its licence conditions and the scheme's constitution and compliance plan[997] (the compliance duty).

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992 See the dissenting judgment of Keane J in *Willmott Growers Group Inc v Willmott Forests Limited (Receivers and Managers Appointed) (In Liquidation)* [2013] HCA 51 at [133].
993 s 601FD(1)(a).
994 s 601FD(1)(b).
995 s 601FD(1)(c).
996 s 601FD(1)(d), 601FD(1)(e).

In addition to the compliance duty under s 601FD, the duty of care and diligence that officers of an RE have both under the general directors' duty provision[998] and under the equivalent provision for officers of an RE in s 601FD[999] requires that those officers facilitate the RE's compliance with its statutory obligations.[1000]

Other obligations of 'officers' under Chapter 5C include:

- an obligation, also imposed on the RE itself, to assist ASIC in carrying out a surveillance check[1001]
- an obligation to allow the auditor of the compliance plan to have access to the books of the scheme and to give the auditor information and explanations for the purposes of the audit.[1002]

Under paragraphs (c)-(g) of the definition of 'officer of a corporation' in s 9, various external administrators of a corporation are 'officers of the corporation'.[1003] However, that definition applies 'unless the contrary intention appears'.[1004] The courts have found that there is a contrary intention in the case of external administrators of an RE of a scheme.

In *Norman, in the matter of Forest Enterprises Australia Ltd (admin apptd) (recs and mgrs apptd) v FEA Plantations Ltd (admin apptd) (recs apptd)*,[1005] the Court, in considering whether the duties of officers of an RE in s 601FD applied to 'a receiver, or receiver and manager, of the property of the corporation' (para (c) of the definition of 'officer of a corporation'), found that there was a 'contrary intention' in s 601FD. The Court referred[1006] to the ALRC/CASAC report, which provided a draft provision for what has become s 601FD. The draft provision contained the following definition of 'officer' that was to apply in this context:

> 232AA(8) In this section:
>
> 'officer', in relation to a body corporate, means a director, secretary or other executive officer of the body corporate.

This draft provision was reflected in the original managed investment amendments introduced by the *Managed Investments Act 1998*. Under s 9 as amended by that Act, 'officer':

> (a) in relation to the responsible entity of a registered scheme — means a person who is a director, secretary or executive officer of the responsible entity; or
>
> (b) in any other case — has the meaning given by section 82A.

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997 s 601FD(1)(f).
998 s 180.
999 s 601FD(1)(b).
1000 This principle was applied, for instance, in *ASIC v Vines* [2005] NSWSC 738 at [1182]-[1183] in relation to the continuous disclosure obligation of a company that was not an RE.
1001 s 601FF.
1002 s 601HG(6).
1003 These are a receiver, or receiver and manager, of the property of the corporation (para (c)), an administrator of the corporation (para (d)), an administrator of a deed of company arrangement executed by the corporation (para (e)), a liquidator of the corporation (para (f)) and a trustee or other person administering a compromise or arrangement made between the corporation and someone else (para (g)).
1004 s 9.
1005 [2010] FCA 1274.
1006 See particularly at [23]-[34].

The definition of 'officer' in s 82A included receivers and managers of property of a body corporate, as well as the other categories of external administrator.

Subsequently, the *Corporate Law Economic Reform Program Act 1999* repealed the definition of 'officer' in s 9 and replaced it with a definition that made no special provision for the meaning of 'officer' in relation to the RE of a scheme and included the current references to 'a receiver, or receiver and manager, of the property of the corporation' and other external administrators.[1007]

Against this background, the Court in the *Norman* case considered it 'clear that the new legislation did not intend to bring about a change in the regulation of managed investment schemes'.[1008] It also pointed out that the CLERP amendments did not concern the effectiveness of the operation of managed investment schemes.[1009]

The Court added:[1010]

> the conclusion is confirmed by what I see as the object of s 601FD(1). The object is to complement the duties owed by the responsible entity. That is achieved by imposing duties on persons who control the responsible entity's activities in the administration of a managed investment scheme and its dealings with scheme assets. A receiver, particularly a receiver who is not also a manager, plays no part in the administration of a scheme nor in the decisions regarding the investment of scheme assets.
>
> A party appointed receiver has different functions. They are, as I have said, to take possession of the charged assets (which in this case do not include scheme assets) and realise them to pay out the debt due to the chargee. There is no reason to bring such a person under the operation of s 601FD(1). *A fortiori* in the case of court appointed receivers and liquidators who, being court officers, owe their duties to the court that appointed them. Indeed those duties may be in conflict with the duties set out in s 601FD(1).

Later, the Court commented:[1011]

> even if, contrary to my view, the receivers are under the duties imposed by s 601FD(1), that would not assist growers. A duty to act in the best interests of the growers cannot, in my opinion, be used as a justification for the responsible entity or its officers to ignore bargains freely entered into. Put bluntly, neither s 601FC nor s 601FD permits a responsible entity to breach, or its officers to procure a breach of, obligations that the responsible entity or a related company owes to a third party. It follows that s 601FD(1) does not prevent a receiver from realising charged assets (including putting those assets into a proper condition for sale) to enable payment of the debt due to the secured creditor.
>
> I accept that the duty (if there be one) could come into play if the receiver has available to him/her alternative courses of action; one that would advantage and the other that would disadvantage investors. In that event the receiver would be required to take the course that would avoid harm to investors. This, however, is not one of those cases.

Similarly, the Court in *Owen, in the matter of RiverCity Motorway Pty Limited (Administrators Appointed) (Receivers and Managers Appointed) v Madden (No 3)*,

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1007 Item 113 of Part 3 of Schedule 3. This amending legislation was discussed in the *Norman* case at [35]-[40].
1008 at [40].
1009 ibid.
1010 at [41]-[42].
1011 at [45].

adopting the reasoning in the *Norman* decision, held that an administrator of an RE was not an 'officer' for the purposes of Chapter 5C and, in particular, s 601FD.[1012]

Analysis and discussion

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.

However, whether that principle should be applied so as to classify an external administrator of an RE as an officer of that RE may depend on:

- the type of duty or obligation, and
- the type of external administrator.

Type of duty

There is a clear policy rationale for excluding external administrators of an RE from being officers of that RE in relation to the 'best interests' duty.

Officers of a company must place the interests of the company above their own where there is a conflict between the two sets of interests. Where a company is solvent, the company's interests are reflected in the interests of the company's members. However, when the company is insolvent or likely to become insolvent, the company's interests are reflected in the interests of the company's creditors.[1013] There is therefore no problem if external administrators are treated as officers of an insolvent company, given that their duties in both roles focus on the interests of creditors.

By contrast, for schemes, in addition to the duties that officers of an RE have in that capacity (including to prefer the RE's interests to their own):

- the RE has duties to scheme members (s 601FC)
- the officers of the RE have duties to scheme members that are similar to, and thus reinforce, those of the RE (s 601FD)[1014]
- the RE's officers (as well as the RE itself) must prefer the interests of scheme members to those of the RE when there is a conflict between the two sets of interests (ss 601FC and 601FD).[1015]

As indicated in the *Norman* and *Owen* cases, this legislative structure does not readily lend itself to treating external administrators of the RE as officers of the RE. External

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1012 [2012] FCA 313. The Court in the *Owen* decision (at [40]) said that the comment of the Full Court of the Federal Court in *Norman; Re Forest Enterprises Ltd v FEA Plantation Ltd* [2011] FCAFC 99 (at [208]) that it was 'not persuaded that [the judge at first instance] erred in the ultimate conclusion to which he came' was neutral, neither expressly supporting nor expressly refuting the reasoning of the Court at first instance.

1013 *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722.

1014 The ALRC/CASAC report (at para 10.16) said that investors should be able to take action to enforce their rights against the officers of the RE directly, without first proceeding against the RE itself. The Court in *Norman, in the matter of Forest Enterprises Australia Ltd (admin apptd) (recs and mgrs apptd) v FEA Plantations Ltd (admin apptd) (recs apptd)* [2010] FCA 1274 at [41] saw the object of the imposition of duties on officers of the RE in s 601FD(1) as being 'to complement the duties owed by the responsible entity'. This observation was quoted in *Owen, in the matter of RiverCity Motorway Pty Limited (Administrators Appointed) (Receivers and Managers Appointed) v Madden (No 3)* [2012] FCA 313 at [30].

1015 s 601FD(1)(c).

administrators of the RE would encounter a conflict between their duties to creditors of the RE and their duties, as officers of the RE, to members of the scheme.

However, it is not clear why external administrators should not be subject to the duties to act honestly, exercise care and diligence and not misuse information or their position or why they should not have obligations to assist ASIC and the auditor of the compliance plan.[1016] In relation to compliance, the external administrator may be the only person in a position to act, given that directors often resign on the appointment of the external administrator and, where an administrator or a liquidator is appointed, the powers of directors and other officers are suspended.[1017] Compliance may involve ensuring that the RE complies with its general legal obligations in respect of the scheme (such as the preparation of scheme accounts and reporting to scheme members) as well as ensuring compliance with the scheme requirements in Chapter 5C.

One approach to the potential for conflict inherent in applying the 'best interests' duty to external administrators of the RE is to ensure that an external administrator of the RE is not an officer of the company in this context. If necessary, the approach adopted by the courts could be confirmed by legislative amendment.

An alternative approach is to treat an external administrator of the RE as an officer of the RE, but ensure that there is no potential for conflict arising out of the 'best interests' duty.

If the SLE Proposal is adopted,[1018] the treatment of schemes would be aligned with that of companies in that the 'best interests' duty would be owed to the MIS (which is the separate legal entity under that Proposal and has rights and obligations analogous to those of a company), rather than to scheme members. In that case, the duty of the RE and its officers to the MIS would operate in the same way as a director's duty to the company: it would focus on the interests of members while the scheme was solvent and on the interests of creditors when the scheme was, or was likely to become, insolvent.[1019] There would therefore be no problem in treating an external administrator of the RE as an officer of the RE.

A similar result could be achieved if the SLE Proposal is not adopted, though in a less straightforward manner. A possible approach would be to modify the 'best interests' duty, though the modified duty would need to distinguish between solvent schemes and insolvent schemes, so that:

- while the scheme is solvent the duty would be owed to the members
- when the scheme is insolvent (or likely to become insolvent), the officers would have to take into account the interests of creditors of the RE in relation to the scheme to the extent (if any) that the RE has recourse to scheme property to meet the debts.[1020]

A modification of the 'best interests' duty along these lines may enable officers of the RE, including external administrators if they came within that definition, to respond more

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1016 ss 601FF, 601HG(6).
1017 ss 437C (administrators), 471A(liquidators).
1018 The SLE Proposal is summarised in Section 1.1.1 of this paper.
1019 CAMAC proposed in the 2012 CAMAC report (Section 6.3.2) that a scheme should be defined as insolvent if the scheme property is insufficient to meet all the claims that can be made against that property as and when those claims become due and payable.
1020 The suggested operation of the 'best interests' duty, whether under the SLE Proposal or the alternative approach, is consistent with Section 7.5.7 of the 2012 CAMAC report, which did not favour the liquidator of a scheme having any statutory duty to scheme members.

appropriately to the circumstances of the scheme. They could have regard to the interests of scheme creditors when the scheme was insolvent. Equally, they could protect the interests of scheme members in those situations where the RE is in external administration but the scheme itself is solvent.

Type of external administrator

It may be appropriate to treat administrators and liquidators of an RE as officers of the RE, as:

- the powers of other company officers are suspended when an administrator or liquidator is appointed to the company[1021]
- they have control over all the RE's affairs.

Similarly, it may be appropriate to treat as an officer of the RE a receiver and manager appointed to take control of the whole, or substantially the whole, of the RE's property,[1022] given the control that such a person has over the RE's affairs.

By contrast, it may not be appropriate to treat a receiver appointed only to some of the RE's property as an officer of the RE, given that:

> A receiver, particularly a receiver who is not also a manager, plays no part in the administration of a scheme nor in the decisions regarding the investment of scheme assets.[1023]

If a voluntary administration procedure is introduced for managed investment schemes,[1024] there may also be a potential for conflict of duties for an administrator who is appointed to the RE and to one of the schemes that it operates. This potential conflict would be avoided by a requirement that each newly-established scheme be operated by a sole-function RE.

Question 12.4.1. Should the definition of 'officer of a corporation' be amended to clarify whether an external administrator of the RE of a managed investment scheme is, or is not, covered by the definition?

Question 12.4.2. If it is made clear that the definition extends to external administrators of an RE:

- should it apply to all provisions affecting officers of the RE and, if not, which provisions should be excluded and why
- should it apply to all external administrators of the RE and, if not, which categories of external administrator should be excluded and why?

Question 12.4.3. Should the duty of officers of the RE to act in the best interests of members be modified to allow for the situation where the scheme is, or is likely to become, insolvent?

1021 ss 437C (administrators), 471A(liquidators).
1022 cf s 441A.
1023 *Norman, in the matter of Forest Enterprises Australia Ltd (admin apptd) (recs and mgrs apptd) v FEA Plantations Ltd (admin apptd) (recs apptd)* [2010] FCA 1274 at [41], quoted in *Owen, in the matter of RiverCity Motorway Pty Limited (Administrators Appointed) (Receivers and Managers Appointed) v Madden (No 3)* [2012] FCA 313 at [30].
1024 2012 CAMAC report Chapter 6.

12.5 Notification of appointment of receiver

The issue

The provisions requiring notification of the appointment of a receiver to property of a company may give a misleading impression of the financial condition of some companies and may cause particular problems when applied to the RE or a corporate custodian of a managed investment scheme.

Current position

When a person appoints a receiver to property held by a company:[1025]

- the person must lodge with ASIC a form giving notice of the appointment within 7 days.[1026] Once ASIC has processed the form, the letters 'EXAD' (indicating that an external administrator has been appointed) appear against the company's name when a search of the company name is done on the ASIC website

- the company must set out in every public document and negotiable instrument, after its name first appears, that a receiver or receiver and manager has been appointed.[1027]

These notification requirements apply in the context of a managed investment scheme:

- whether the receiver is appointed to all of the property held by an RE or by a corporate custodian or to a particular item or particular items of property

- whether the receiver is appointed to personal assets of the RE or a corporate custodian or to scheme property that is held on trust for scheme members by the RE or by a corporate custodian.[1028]

Analysis and discussion

The notification requirements do not provide any means for indicating:

- how much of the property of the company is affected by the appointment of a receiver (the partial appointment issue), or

- the capacity in which the company holds the property to which a receiver has been appointed (the capacity issue).

The partial appointment issue can affect any company that has had a receiver appointed to some of its property, even though other company property is unaffected and the company remains solvent.

The capacity issue affects any company that holds property on trust. This issue is particularly relevant to an RE, which must hold scheme property on trust for scheme

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1025 The notification requirements refer to 'a corporation'. 'Corporation' includes a company: s 57A. The discussion in this section of this paper refers to a 'company', as an RE must be a public company: s 601FA.

1026 s 427, Form 504.

1027 s 428.

1028 The RE (or a custodian if one is engaged by the RE) holds the legal title to scheme property. The definition of 'property' in s 9 extends to a legal or equitable estate or interest (whether present or future and whether vested or contingent) in any real or personal property.

members.[1029] The notification requirements do not enable a distinction to be drawn between:

- an appointment to scheme property of a scheme that the RE operates, and
- an appointment to the RE's personal assets due to financial difficulties that the RE is experiencing in relation to its own affairs.[1030]

In the case of an appointment to scheme property, there is no means of indicating that the RE is not itself insolvent or otherwise in financial difficulties and that the property to which the receiver has been appointed is scheme property held on trust for scheme members. The notification requirements may therefore mislead creditors or investors about the financial state of the RE.

Conversely, in the case of an appointment to the RE's personal assets, the notification requirements may mislead the market about the financial state of a scheme for which it is the RE.

This lack of detail may not unduly affect a sole-function RE, whose affairs are identical to those of the scheme that it operates. If a receiver is appointed to the scheme property, public notification that a receiver has been appointed to property held by the RE would not be misleading (unless the partial appointment issue is relevant).

However, the capacity issue is more likely to affect a multi-function RE. If a receiver is appointed to property held by a multi-function RE in relation to one of its schemes, there is no scope for the notification to specify that the appointment relates to property of that scheme and not to property that the RE holds for other schemes or to the RE's personal assets. A multi-function RE that has sufficient assets of its own may choose to prevent the appointment of a receiver (and any consequential reputational damage to itself and to the other schemes that it operates) by paying the relevant debt. However, a multi-function RE that only operates schemes, and does not own any substantial property apart from sufficient capital to satisfy the minimum capital requirements of its licence, may not be in a position to pay the debt.

In addition, in most cases, REs enter into transactions on a limited recourse basis, so that their personal liability for the relevant debts is limited to the amount that they are entitled to recover out of the scheme property under their indemnity rights.[1031] The notification requirements may detract from the benefits of using limited recourse financing, as a secured creditor who has not been paid in full may appoint a receiver to the relevant property, thus triggering the notification requirements, even where the RE is solvent.[1032] This factor affects any company that utilises limited recourse financing, including sole-purpose REs as well as multi-purpose REs.

Similar problems to those discussed above may affect corporate custodians who hold scheme property on behalf of the RE.

1029 s 601FC(2).

1030 These affairs include the RE's right to be the RE of the scheme and the right of indemnity that goes with that role.

1031 Depending on the terms of the financing agreement, the limitation of the RE's liability may be to the amount that can be realised from a particular asset or assets or to the RE's indemnity rights against all of the scheme property for the relevant scheme.

1032 The RE can be solvent even though the full amount of the debt is not paid, as the limited recourse rights agreed to by the lender mean that the RE is not liable for any shortfall remaining after realisation of the security property.

The problems for REs and corporate custodians would be resolved if the notification requirements in relation to the appointment of a receiver enabled a notification to make clear the capacity in which the receiver had been appointed.

One way to achieve this goal, at least in relation to the capacity issue, would be through adoption of the SLE Proposal,[1033] as the scheme property to which a receiver is appointed would be held by the MIS, not by the RE, and any notification requirements would apply to the MIS, not to the RE. The RE would be an agent only and neither its personal assets nor the property of any other schemes that it operates would be affected.

If the SLE Proposal is not adopted, a requirement that each newly-established scheme be operated by a sole-function RE would avoid the capacity issue (but not the partial appointment issue).

Question 12.5.1. Should the public notification requirements on appointment of a receiver to property of a corporation be amended and, if so, how?

Question 12.5.2. How significant is the problem identified in this section in practice?

[1033] The SLE Proposal is summarised in Section 1.1.1 of this paper.

13 Regulatory powers and enforcement

This chapter discusses ASIC's powers in relation to schemes. It also examines the consequences for transactions of contraventions of the managed investment provisions.

13.1 Modification and exemption powers

The issue

Should ASIC's discretionary exemption and modification powers in relation to schemes be expanded?

Should ASIC have the power in all instances to extend the period for doing an act after that period has ended?

Current position

ASIC has the power to:

- exempt a person from some or all of the provisions of Chapter 5C of the Corporations Act in relation to some or all persons
- modify the operation of specified provisions in Chapter 5C in relation to some or all persons.[1034]

ASIC also has a range of other modification powers that are relevant to registered schemes.[1035]

However, ASIC does not have modification powers in relation to:

- the provisions governing meetings of members of registered managed investment schemes (except in very limited circumstances)[1036]
- the 'disclosing entity' provisions in Part 1.2A of the Corporations Act, which are relevant to the continuous disclosure requirements[1037]

1034 s 601QA. Regulatory Guide 136 *Managed investments: Discretionary powers and closely related schemes* gives guidance on when ASIC will give relief.

1035 For instance, Part 2M.6 (financial reports and audit), s 655A (takeovers)

1036 Most of the provisions governing scheme meetings are in Part 2G.4. ASIC has no modification and exemption powers in relation to these provisions.
ASIC can use its Chapter 5C modification powers where the requirement for a meeting is in Chapter 5C itself. For instance, under s 601FL, an RE that wants to retire must call a meeting of members to explain its reasons and to enable the members to vote on a resolution to choose a new RE. Similarly, a meeting is required to pass a special resolution to effect a change to the scheme's constitution under s 601GC. If ASIC is exercising its powers under s 601QA to modify s 601FL or s 601GC, it could, as part of the modification, impose procedural requirements that would change what would otherwise occur under Part 2G.4. This approach requires the drafting of unduly complex instruments.

1037 ASIC has exemption and modification powers in relation to the 'disclosing entity provisions': Part 1.2A Div 4. However, the expression 'disclosing entity provisions' is defined to cover only Chapter 2M (financial reports and audit) as it applies to disclosing entities and ss 674 and 675 (the continuous disclosure provisions), not Part 1.2A itself. The absence of any ASIC modification powers in relation to the disclosing entity provisions in Part 1.2A is discussed in Section 14.1 of this paper in relation to recognised New Zealand schemes.

- the registers provisions in Chapter 2C of the Corporations Act
- the mutual recognition provisions in Chapter 8 of the Corporations Act (discussed further in Section 14.1 of this paper).

In addition, there may be limitations on ASIC's ability to extend the period for doing an act required by the Corporations Act. Section 70 of the Corporations Act provides:

> Where this Act confers power to extend the period for doing an act, an application for the exercise of the power may be made, and the power may be exercised, even if the period, or the period as last extended, as the case requires, has ended.

Many of the statutory obligations in the Corporations Act do not include a power for ASIC to extend the period for complying with the obligation.[1038] Section 70 may therefore not enable a person to make, or ASIC to deal with, an extension application after the end of the statutory period.

Analysis and discussion

The limitations on ASIC's ability to provide relief through the exercise of its exemption and modification powers arise regardless of whether the powers relate to companies or schemes, though the difficulties experienced to date have related to schemes.

It may be particularly desirable for ASIC to have the same administrative flexibility in relation to companies and schemes, especially where an exemption or modification application relates to a stapled entity.[1039]

The need for ASIC to have relief powers may currently be greater for schemes than for companies in relation to the provisions governing meetings, given that some of the meetings provisions for companies can be overridden by a company's constitution,[1040] whereas equivalent schemes provisions cannot be altered by a scheme's constitution. However, CAMAC has raised for consideration whether the meeting provisions for companies and schemes should be brought into alignment (see Chapter 8 of this paper).

Question 13.1.1. Should ASIC have powers to make modifications and exemptions in relation to:

- the provisions governing meetings
- the 'disclosing entity' provisions in Part 1.2A of the Corporations Act
- the registers provisions in Chapter 2C of the Corporations Act
- the mutual recognition provisions in Chapter 8 of the Corporations Act
- any other provisions where it currently lacks this power?

Question 13.1.2. Should these powers apply equally to schemes and companies and, if not, why not?

1038 For instance, s 315 (deadline for financial reporting to members).

1039 In a stapled structure, investors hold shares in a company (which usually takes the active role of operating the enterprise) and interests in a scheme (through which the property of the enterprise is held) and the company shares and scheme interests can only be purchased and sold together.

1040 The relevant provisions are categorized as replaceable rules (s 135).

Question 13.1.3. Should ASIC have the power in all instances to extend the period for doing an act after that period has ended?

13.2 Supervisory and enforcement powers

The issues

What, if any, additional powers should ASIC have?

What, if any, breaches not currently covered by the civil penalty regime should be covered by that regime (for instance, breaches of the withdrawal provisions in Part 5C.6)?

Current position

ASIC has a range of surveillance, information-gathering, investigative and enforcement powers that it can use in relation to schemes. These powers are contained in the Corporations Act (the managed investment scheme provisions in Chapter 5C, the licensing provisions in Chapter 7 and various provisions concerning offences and court powers[1041]) and in the ASIC Act (Parts 3 and 3A).[1042]

ASIC's enforcement powers include the power to apply for a declaration of contravention, a pecuniary penalty order or a compensation order.[1043] These civil penalties, which came into effect in 1993, provide a more expeditious means of enforcing some parts of the Corporations Act than a criminal prosecution. Civil penalties are available on proof to the civil standard that a contravention has occurred.

When the court is satisfied that a person has contravened one of the civil penalty provisions, it must make a declaration of contravention.[1044] A declaration of contravention opens the way to a range of further regulatory options. Once a declaration of contravention has been made in relation to a person, a court can also order the person to pay a pecuniary penalty.[1045] The court may also disqualify a person from managing corporations if a declaration of contravention has been made in relation to the person.[1046]

The range of provisions that are 'civil penalty provisions'[1047] was expanded in 1998 (including by adding to the list of civil penalty provisions some provisions in the newly introduced Chapter 5C dealing with managed investments) and 2001.[1048] In relation to schemes, the relevant regulatory requirements that attract the civil penalty provisions are:

1041 For instance, ss 1315 (power to commence proceedings), 1317J (power to apply for a declaration of contravention, a pecuniary penalty or a compensation order for breach of a civil penalty provision) and 1323, 1324 and 1325 (powers to seek preservative orders, injunctions, and orders affecting contracts or requiring the payment of damages).

1042 See further P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶70-300-¶70-400.

1043 s 1317J.

1044 s 1317E.

1045 s 1317G. The court can also make a compensation order if a civil penalty provision has been contravened, whether or not a declaration of contravention has been made: s 1317H.

1046 s 206C.

1047 s 1317E(1).

1048 *Company Law Review Act 1998*, *Managed Investments Act 1998*, *Financial Services Reform Act 2001*. See further HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [3.400].

- the related party provisions[1049]
- the duties of the RE and its officers and employees[1050]
- the provision governing acquisition of an interest in a scheme by its RE[1051]
- the duties of members of a compliance committee[1052]
- the financial records requirements and the financial reporting requirements[1053]
- the continuous disclosure provisions[1054]
- various market offences.[1055]

Analysis and discussion

Some additional enforcement powers may assist ASIC in regulating managed investment schemes.

For instance, the scheme's constitution and compliance plan are key elements of the governance framework for schemes (see Sections 5.2.2 and 5.3.1 of this paper). ASIC has the power to check whether an RE is complying with the constitution and compliance plan.[1056] This power might be complemented by powers:

- to require production of any document
- to require disclosure of information known to an agent (or former agent) or other person engaged by the RE.

Also, Product Disclosure Statements and periodic statements are important elements of the disclosure framework for schemes (see Sections 10.4.3 and 10.6, respectively, of this paper). It may be beneficial for ASIC to have the power to require additional content for these documents.

Furthermore, it may assist effective enforcement if provisions applicable to schemes that are not currently subject to the civil penalty regime are made subject to that regime. For instance, the provisions governing withdrawal from a scheme (Part 5C.6) are not civil penalty provisions. By contrast, the various provisions relating to share capital transactions attract the civil penalty regime.[1057] These share capital provisions can provide a means for a company shareholder to withdraw from the company.

1049 ss 601LA (which applies the related party transaction provisions in Chapter 2E to a registered scheme), 209(2) (which is the civil penalty provision) and 1317E(1)(b).
1050 ss 601FC(5), 601FD(3), 601FE(3), 1317E(1)(f)-(h).
1051 ss 601FG(2), 1317E(1)(i).
1052 ss 601JD(3), 1317E(1)(j).
1053 ss 344, 1317E(1)(d).
1054 ss 674(2), 674(2A), 675(2), 675(2A), 1317E(1)(jaab).
1055 ss 1041A (market manipulation), 1041B(1) (false trading and market rigging - creating a false or misleading appearance of active trading), 1041C(1) (false trading and market rigging - artificially maintaining market price), 1041D (dissemination of information about illegal transactions), 1043A(1), (2) (insider trading), 1317E(1)(jb)-(jg).
1056 s 601FF.
1057 ss 254L(2), 256D(3), 259F(2), 260D(2), 1317E(1)(c).

CAMAC's general approach is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently. On that basis, the withdrawal provisions might constitute civil penalty provisions if they are seen as performing a capital management function similar to that performed by the company share transaction provisions, at least in certain respects.

Question 13.2.1. What, if any, additional powers should ASIC have in relation to managed investment schemes and why?

Question 13.2.2. Should the withdrawal provisions in Part 5C.6 be governed by the civil penalty regime?

Question 13.2.3. Should any other provisions in Chapter 5C not currently subject to the civil penalty regime be governed by that regime and, if so, what provisions?

13.3 Consequences of contraventions for transactions

The issue

The Corporations Act does not specify the consequences of a contravention of particular provisions in Chapter 5C for relevant transactions. This may lead to commercial uncertainty or require litigation to determine whether a transaction that involves a contravention is valid or enforceable.

Current position

Some Corporations Act provisions specify whether a transaction that contravenes a particular provision is or is not invalid.[1058] However, none of the managed investment provisions state whether or not a contravention of those provisions causes invalidity.

Also, s 103 of the Corporations Act provides that an 'act, transaction, agreement, instrument, matter or thing is not invalid merely because of a contravention of' certain provisions. However, these provisions do not include any of the managed investment provisions in Chapter 5C.

Section 103 'has been taken not to imply that contravention of other sections does involve invalidity'.[1059] Where there is no indication of whether a contravention of a provision causes invalidity, 'it is necessary to apply the principles of the general law of contract dealing with illegal contracts'.[1060] There are various factors relevant to a determination of whether Parliament 'has shown an intention to invalidate a contract associated with a contravention', 'none of which by itself is determinative':[1061]

- whether the provision is for the protection of the public (or a section of the public) or something else, such as the revenue — if not, invalidation was not intended
- whether a penalty is prescribed — absence of a penalty points to invalidation

[1058] See, for instance, ss 125, 191, 192, 195, 201M, 204E.
[1059] HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [3.430], citing *Re Macro Constructions Pty Ltd* [1994] 2 Qd R 31; (1992) 8 ACSR 719; 10 ACLC 1722.
[1060] ibid.
[1061] ibid.

- the type of any prescribed penalty
- the size of any penalty relative to loss arising from invalidation
- the effect of invalidation — whether it would create a public mischief outweighing the public benefit of invalidation.

In *MacarthurCook Fund Management Limited v Zhaofeng Funds Limited*,[1062] the Court resolved this question in relation to one area of the managed investment provisions. It held that an offer to withdraw from a non-liquid scheme that breaches the legislation (by virtue of failing to satisfy the requirement to specify the period during which the offer would remain open[1063]) is not for that reason alone invalid.[1064]

Analysis and discussion

Uncertainty about the validity of a transaction entered into in contravention of one of the managed investment scheme provisions in Chapter 5C may cause legal and therefore commercial uncertainty. For instance, an RE may purport to amend a scheme constitution unilaterally on the basis that the RE 'reasonably considers the change will not adversely affect members' rights'.[1065] Outside parties may be reluctant to enter into transactions that depend on the amendment if there is a risk that litigation may be necessary to determine the validity of those transactions.

Although a court may be reluctant to find that transactions are invalid in some circumstances (particularly where third parties have obtained rights[1066]), the risk of invalidity remains in the absence of a clear legislative statement about the consequences of a contravention.

Question 13.3.1. Should the consequences of contravention of any of the managed investment provisions for relevant transactions be stipulated in the Corporations Act?

Question 13.3.2. In particular, should certain provisions state that a contravention will not render any associated transactions invalid? If so, which provisions?

1062 [2012] NSWSC 911.
1063 s 601KB(3)(a).
1064 See further P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶13-300.
1065 s 601FC(1)(b). This amendment power of the RE is discussed in Section 6.3 of this paper.
1066 In *Premium Income Fund Action Group Incorporated v Wellington Capital Limited* [2011] FCA 698, the Court refused to hold that an issue of units was invalid, in view of the fact that it may not be possible to identify or trace the purchasers of newly traded units for the purpose of preventing the exercise of their rights as unit holders (at [50]).

14 International aspects

This chapter discusses the provisions that facilitate the marketing of New Zealand schemes in Australia. It also raises for consideration the possible implementation in Australian law of international principles for the regulation of managed investment schemes and whether the Australian regulatory framework should be expanded to accommodate alternative managed investment structures.

14.1 Recognised New Zealand schemes

The issues

Should a dispute resolution procedure be available at all times to persons who invest in recognised New Zealand schemes, regardless of whether any of those investors continue to reside in Australia?

Is it appropriate that a New Zealand entity that is listed in Australia is regulated as an unlisted disclosing entity?

Current position

Overview of the provisions

Chapter 8 of the Corporations Act (in combination with Chapter 8 of the Corporations Regulations) enables securities that comply with the New Zealand securities law to be marketed in Australia without having to comply with the substantive requirements of the securities, fundraising and licensing provisions of the Corporations Act.[1067] New Zealand has reciprocal provisions for Australian schemes.[1068]

Where an offer of interests in a New Zealand scheme meets the requirements of Chapter 8,[1069] the New Zealand scheme does not need to apply to be registered by ASIC and the trustee of that scheme does not need to prepare a Product Disclosure Statement or hold an Australian financial services licence for the purposes of an initial public offer or any secondary offer.

[1067] s 1200F. Chapter 8, introduced by the *Corporations (NZ Closer Economic Relations) and Other Legislation Amendment Act 2007*, provides a general mechanism for mutual recognition of securities offers by entities registered in other jurisdictions. So far New Zealand is the only other jurisdiction to be recognised: definition of 'recognised jurisdiction' in s 1200(1), Corp Reg 8.1.03. However, the provisions 'are drafted in such a way that they could be extended to other countries if comparable arrangements were reached with them' (Explanatory Memorandum to the Bill for the *Corporations (NZ Closer Economic Relations) and Other Legislation Amendment Act 2007*, para 1.7; see also paras 5.7, 5.36-5.41).
Chapter 8 implements the *Agreement between the Government of Australia and the Government of New Zealand in relation to Mutual Recognition of Securities Offerings*, agreed between Australia and New Zealand in February 2006. The initiative is 'consistent with the *Australia-New Zealand Closer Economic Relations Trade Agreement* which has shaped the economic and trade relationship between the two nations since 1983' (Explanatory Memorandum para 1.3).

[1068] *Securities Act 1978* (NZ) Part 5.

[1069] Part 8.2 Div 1.

A New Zealand issuer who wants to make an offer of interests in a managed investment scheme in Australia under the Chapter 8 regime (a 'recognised offer'[1070]) must:

- prepare disclosure required under Part 2 of the *Securities Act 1978* (New Zealand),[1071] and
- lodge with ASIC a written notice of the intention to make the offer, including an offer document that is accompanied by a warning statement.[1072] The issuer must also notify the New Zealand Companies Office.

Requirement to have a dispute resolution scheme

A New Zealand offeror of interests in a managed investment scheme[1073] who comes within Chapter 8 of the Corporations Act must have the same type of dispute resolution process as a person who is required to give a Product Disclosure Statement.[1074] That process must consist of:

- an internal dispute resolution procedure that complies with ASIC-approved standards and covers complaints by retail clients, and
- membership of an external dispute resolution scheme that is approved by ASIC and covers complaints by retail clients.

The New Zealand offeror must have this process 'at all times when the person's records indicate that someone who resides in this jurisdiction holds securities in the class of securities that was the subject of the recognised offer'.[1075]

ASIC can exempt a person from the requirement to have a dispute resolution process, subject to any conditions that ASIC may impose.[1076] A person to whom ASIC has given an exemption has no express statutory obligation to comply with any conditions imposed by ASIC. This contrasts with ASIC's exemption and modification power in relation to the managed investment provisions in Chapter 5C.[1077]

Application of the continuous disclosure provisions

A New Zealand scheme is only a disclosing entity (and therefore subject to the continuous disclosure requirements in Chapter 6CA of the Corporations Act) if 100 or more people who reside in Australia have held interests in the scheme at all times as a result of a recognised offer since the interests were issued.[1078]

1070 For the concept of 'recognised offer', see s 9 definition of recognised offer, ss 1200B and 1200C and Corp Regs 8.1.03 and 8.2.01.

1071 This Act will eventually be replaced by the *Financial Markets Conduct Act 2013* (New Zealand). It will be necessary to amend Chapter 8 of the Corporations Regulations.

1072 s 1200D.

1073 This covers offers of primary and secondary interests in those schemes. See Section 16.3 of this paper for a discussion of the concepts of 'primary' and 'secondary' interests.

1074 s 1200J (the Chapter 8 dispute resolution requirement), s 1017G(2) (the PDS dispute resolution requirement).

1075 s 1200J(1).

1076 s 1200J(3).

1077 s 601QA(3).

1078 s 111AFA(2). This provision refers to people who reside 'in this jurisdiction'. Section 9 defines 'this jurisdiction' as referring to the geographical area consisting of each of the States, the Australian Capital Territory, the Northern Territory and, in some circumstances, an external Territory.

A New Zealand scheme cannot be a listed disclosing entity: it can only be an unlisted disclosing entity, even if it is listed on an Australian exchange (and on the New Zealand Stock Exchange).[1079]

New Zealand schemes, whether or not they are listed, are therefore required to lodge their continuous disclosure notices with ASIC.[1080] Currently, there is only one listed New Zealand scheme in this situation: it is the only listed entity that is not required by the Corporations Act to lodge its continuous disclosure notices with the exchange on which it is listed. ASIC has no power to modify the disclosing entity provisions in Part 1.2A of the Corporations Act to overcome this situation.

Analysis and discussion

Requirement to have a dispute resolution scheme

The requirement for a New Zealand offeror to maintain a dispute resolution process does not apply where the only persons holding interests in the scheme are not resident in Australia,[1081] even if they were in Australia when they received the recognised offer. The policy rationale for linking continuing residence and Australian dispute resolution requirements is unclear. It may be that a dispute resolution process is seen as being primarily for the benefit of resident investors. However, if that is the case, it is curious that investors who reside outside Australia have access to a dispute resolution procedure if they

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This is the only category of disclosing entity that could apply to a recognised New Zealand scheme. A scheme is a disclosing entity if any interests in the scheme are ED securities: s 111AC(2). The possible categories of ED security are set out in s 111AD(1). The category covered by the 100 person test in s 111AFA(2) is one of those categories. The other categories do not apply to recognised New Zealand schemes for various reasons:

- s 111AE(1A) (managed investment products of a scheme that is included in the official list of a prescribed financial market) only applies to managed investment products of registered schemes. A recognised New Zealand scheme is not a registered scheme for the reasons set out in the next footnote. Also, the concept of 'managed investment product' relates only to registered schemes (definitions of 'managed investment product' in ss 9 and 761A, s 764A(1)(b))
- s 111AF only applies to companies. It contains a 100 person test that is the equivalent of s 111AFA
- s 111AG (securities issued as consideration for an acquisition under an off-market takeover bid or Part 5.1 compromise or arrangement) only applies to 'securities of a body', which does not include interests in a scheme. The continuous disclosure provisions refer to interests in a scheme as being 'issued by a body' rather than as being securities 'of a body' (see s 111AFA). Also, the scheme provisions in Part 5.1 only apply to a 'Part 5.1 body', which is defined under s 9 as a company and a registrable body under Part 5B.2 of the Act
- s 111AI only applies to debentures.

[1079] A New Zealand scheme listed on an Australian exchange is not a 'listed disclosing entity' as defined in the Corporations Act, as:

- an entity is a 'listed disclosing entity' if 'all or any ED securities of the entity are quoted ED securities' (definition of 'listed disclosing entity in s 9, s 111AL(1))
- securities are only 'quoted ED securities' if they are ED securities because of s 111AE (definition of 'quoted ED securities' in s 9, s 111AM)
- the part of s 111AE relating to managed investment schemes (s 111AE(1A)) applies only to 'registered schemes'
- a 'registered scheme' is one that is registered under s 601EB of the Corporations Act (definition of 'registered scheme' in s 9)
- schemes not registered in Australia, including those making a recognised offer under Chapter 8, are not 'registered schemes' under the Corporations Act.

Therefore, a recognised New Zealand scheme can only be a disclosing entity, if at all, as an unlisted disclosing entity, given that 'a disclosing entity that is not a listed disclosing entity is an unlisted disclosing entity' (s 111AL(2)).

[1080] s 675. See, however, the discussion of ASIC Regulatory Guide 198 in Section 10.7.2 of this paper. That Regulatory Guide allows disclosure on a website for unlisted disclosing entities as an alternative to lodgement of a continuous disclosure notice with ASIC.
The continuous disclosure requirement for listed disclosing entities is in s 674.

[1081] The section refers to the client not being in 'this jurisdiction'. Section 9 defines 'this jurisdiction' as referring to the geographical area consisting of each of the States, the Australian Capital Territory, the Northern Territory and, in some circumstances, an external Territory.

invested under a recognised offer received in Australia as long as there is at least one resident investor, but cease to have this access once all investors are non-resident.

In CAMAC's view, a dispute resolution procedure should continue to be available while there are investors who have invested in a New Zealand scheme under a recognised offer, whether or not the scheme has any investors who reside in Australia.

Also, the absence of an express statutory obligation for a person who has been given an exemption from the Chapter 8 mutual recognition provisions to comply with conditions to which that exemption is subject appears to be an oversight and should be rectified.

Application of the continuous disclosure provisions

It is desirable that a listed New Zealand scheme be treated as a listed disclosing entity for the purpose of the continuous disclosure provisions.

This result could be achieved by a legislative amendment to the disclosing entity definitions or by giving ASIC the power to modify those definitions in appropriate cases. The chosen solution would need to take into account that the current continuous disclosure obligations for a listed disclosing entity are imposed on the RE of a registered scheme.[1082] A New Zealand scheme is not a registered scheme and does not have an RE (given that only a registered scheme has an RE, as defined).[1083]

Question 14.1.1. Should the dispute resolution requirement for recognised New Zealand schemes be changed so that it applies regardless of whether any scheme members are resident in Australia?

Question 14.1.2. Where ASIC has given an exemption from the requirement for an offeror of interests in a recognised New Zealand scheme to have a dispute resolution procedure, should there be an express statutory obligation for that offeror to comply with any condition that ASIC imposes on the exemption?

Question 14.1.3. Should overseas schemes operating in Australia under Chapter 8 of the Corporations Act and listed on an Australian exchange be treated as listed disclosing entities for the purpose of the continuous disclosure provisions and, if so, how (for instance, by amendment of the disclosing entity definitions or by giving ASIC a power to modify those definitions in appropriate circumstances)?

Question 14.1.4. Are there any other aspects of the Chapter 8 provisions that require modification?

14.2 Implementation of IOSCO principles

The issue

There are internationally recognised standards of securities regulation, including for the regulation of managed investment schemes.

Some of these standards are not reflected in Australia's regulatory framework for schemes. The issue is whether the Corporations Act should be amended to implement these standards.

1082 s 674(3).
1083 Definition of 'responsible entity' in s 9.

Current position

The International Organization of Securities Commissions (IOSCO) has published *Objectives and Principles of Securities Regulation* (June 2010), which sets out 38 Principles of securities regulation. These Principles are based on three Objectives:

- protecting investors
- ensuring that markets are fair, efficient and transparent
- reducing systemic risk.

Members of IOSCO are expected 'to cooperate in developing, implementing and promoting adherence to internationally recognised and consistent standards of regulation, oversight and enforcement' to achieve these objectives.

Tests for assessing implementation of the IOSCO Objectives and Principles are set out in *Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (September 2011).

ASIC is a member of IOSCO.

Items for consideration

Possible amendments to the Corporations Act to bring it more clearly into line with IOSCO principles include:[1084]

- *Item 1:* introduction of a specific requirement for an RE's website to disclose the identity of agents or other persons engaged in the operation of the scheme and any unusual and significant terms of their engagement[1085]
- *Item 2:* introduction of a specific requirement to disclose the form and structure of a registered managed investment scheme and information about any material risks arising from that form and structure[1086]
- *Item 3:* introduction of a specific requirement to disclose all information necessary to understand how the scheme property and assets of registered schemes are valued and information about the methodology for valuing each asset, subject to a confidentiality carve-out[1087] (issues relating to valuation are discussed in Section 15.1 of this paper)
- *Item 4:* extend the requirement for a PDS to contain 'any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product'[1088] so that it covers a simple

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1084 The footnote to each possible area for amendment identifies the relevant IOSCO Principle and the relevant part of the *Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* ('Methodology').

1085 IOSCO Principle 24, Methodology Key Question 16(d).

1086 IOSCO Principle 25, Methodology Key Questions 1 and 2 (also the second paragraph of the commentary on Principle 25).

1087 IOSCO Principle 26, Methodology Key Questions 1 and 5(e). This would build on the current s 300(13)(e), which requires that the annual report of a registered scheme include details of the value of the scheme's assets at the end of the financial year and the basis for the valuation.

1088 s 1013E.

managed investment scheme[1089] (the disclosure requirements for simple managed investment schemes are discussed in Section 10.4.3 of this paper)

- *Item 5:* introduction of a specific disclosure requirement in relation to documents that confer a right on members of registered schemes[1090]
- *Item 6:* introduction of a specific requirement to disclose who is holding the scheme property or other assets of registered schemes[1091]
- *Item 7:* introduction of a specific requirement to disclose the investment policies to apply for a registered scheme[1092] and a requirement to comply with the policy[1093] (requirements for investment guidelines, including disclosure, are discussed in Section 5.7 of this paper)
- *Item 8:* introduction of a specific requirement to disclose the appointment of any external administrator or investment managers or advisers who have a significant role in relation to a registered scheme[1094]
- *Item 9:* introduction of a specific requirement for regular publication of net asset value (NAV) per unit based on accounting standards[1095] and price of interests.[1096]

Question 14.2.1. For each of the above items, should the Corporations Act be amended to bring it into line with the relevant IOSCO standard and, if so, how?

14.3 UCITS-type regulatory structure for Australian funds

The issue

The current statutory regime for publicly offered managed investment schemes in Australia does not provide for the operation of certain alternative forms of collective investment vehicles that are common in overseas jurisdictions, such as UCITS funds that currently operate under a European Union (EU) Directive.[1097]

Current position

Managed investment schemes regulated under Chapter 5C of the Corporations Act have become one of the main forms of non-superannuation collective investment vehicle in Australia. Other collective investment vehicles operating in Australia include substantial investment funds that operate as life insurance company funds and relate to investment-linked life insurance, and investment companies.

1089 IOSCO Principle 26, Methodology Key Question 4. Section 1013E does not apply to simple managed investment schemes because of Schedule 10A Item 5C.3 of the Corporations Regulations.
1090 IOSCO Principle 26, Methodology Key Question 5(c).
1091 IOSCO Principle 26, Methodology Key Question 5(h).
1092 IOSCO Principle 26, Methodology Key Question 5(i).
1093 IOSCO Principle 26, Methodology Key Question 12.
1094 IOSCO Principle 26, Methodology Key Question 5(k).
1095 IOSCO Principle 27, Methodology Key Questions 1 and 2.
1096 IOSCO Principle 27, Methodology Key Question 7.
1097 Directive 2009/65/EC. Further obligations for UCITS are imposed under Directive 2010/42/EU, Directive 2010/43/EU, Regulation (EU) No 583/2010 and Regulation (EU) No 584/2010.

A UCITS (Undertakings for Collective Investment in Transferable Securities) investment fund structure was introduced by a Directive of the European Economic Community in 1985.[1098] A UCITS fund cannot be registered as a managed investment scheme under the Corporations Act, as the UCITS structure does not include the equivalent of the single responsible entity. Conversely, it is not possible for a registered scheme (that is, a managed investment scheme registered under Chapter 5C of the Corporations Act) to be a UCITS fund. Additionally, the UCITS Directive constitutes a prescriptive regulatory regime, where structural requirements for a UCITS are embedded in the law for a UCITS. Essentially, the managed investment scheme regime in Chapter 5C of the Corporations Act does not contain equivalent requirements.

Analysis and discussion

Purpose of an alternative regulatory structure

An additional alternative form of investment structure may enhance access by the Australian funds industry to foreign markets and offer more product choice for Australian investors. A structure that is modelled on an established and globally recognised structure (such as UCITS funds with their specific investor protection features) may attract investors that prefer highly regulated investments and enhance the ability of industry to compete for fund-related business from foreign investors.

Features of UCITS funds

The UCITS framework has been developed to provide investor protection in the structure of the fund and marketability across EU countries. Once registered (authorised) in one EU country, a UCITS fund can be freely marketed across the EU.

UCITS have proven to be successful and widely used by European households. UCITS have also attracted investors from various other regions such as Asia and are widely recognised by professional and retail investors in the asset management industry. A key feature of UCITS that attracts investors is the favourable tax treatment that is available in the country in which UCITS are based (for example, Luxembourg).

In summary, some of the key EU requirements for a UCITS fund are that it:

- must be authorised by the home country of the fund
- must have a separate depositary, which has certain asset holding and supervisory functions[1099] and must be established or have its registered office in the home country of the fund. This requirement is different from the Australian requirements for a registered scheme, which do not mandate a separate custodian. Also, where an RE chooses to engage a custodian, the custodian does not perform supervisory functions
- must only invest in:
  - certain securities traded on a market
  - certain money market instruments, and

1098 Directive 85/611/EEC, which was superseded by Directive 2009/65/EC.

1099 Under the European UCITS regime, an independent depositary has safekeeping duties and supervisory functions and is a central feature of the UCITS framework. While the fund manager makes investment decisions for the fund, the depositary is responsible for holding the fund's assets in custody on behalf of investors, and such assets are segregated from those of the manager.

  - derivatives subject to certain risk limitations

- is required to have at least a degree of portfolio diversification (for instance, there are limits on the percentage of assets permitted to be invested in a single issuer or group of issuers)
- must be intended to be an open fund (that is, it must offer a redemption facility)
- must provide annual and half–yearly reports containing specified information
- must provide certain disclosure to investors when promoted, and
- in order to be promoted in another EU country, must first be approved by the home country, which must notify the other EU country of the approval.

For the UCITS framework to be operational, each country must adopt the EU requirements into its domestic law, as well as amending the domestic law, as necessary, to allow for the operation and marketing of UCITS funds.

The UCITS framework has evolved since its inception. The European Parliament and the European Council have backed a European Commission proposal to strengthen the rules for UCITS,[1100] including in relation to:

- depositary functions
- remuneration policies
- administrative sanctions.

The European Commission is currently considering other changes to the UCITS framework,[1101] including in relation to:

- efficient portfolio management (in particular, transparency and best practice requirements and liquidity management) to facilitate redemption
- valuation requirements, and
- the requirements for money market instruments in which a UCITS fund can invest.

Question 14.3.1. Should the current regulatory structure for managed investment schemes in Australia be broadened to permit registration of an alternative regulatory structure that is modelled on the regulatory requirements that apply to UCITS?

Question 14.3.2. Would the ability to register a UCITS-like structure enhance the marketability of Australian investment funds to domestic and foreign investors?

Question 14.3.3. What would be the benefits, costs and risks to investors and investment managers of operating a UCITS-like structure in Australia?

[1100] European Commission statement 25 February 2014. The European Commission proposal was announced in Press Release IP/12/736 released on 3 July 2012.

[1101] Consultation Document *Undertakings for Collective Investments in Transferable Securities* published by the European Commission on 26 July 2012.

15 Other matters

This chapter discusses the valuation of scheme assets, the definition of 'financial market' and the exception from the insider trading provisions for withdrawals from registered managed investment schemes. It also raises a general question about the alignment of corporate and scheme law.

15.1 Valuation of scheme assets and liabilities

The issue

Currently, the valuation of scheme assets and liabilities is used for two purposes:

- reporting the value of assets and liabilities in the annual financial reports and directors' reports of schemes required under the Corporations Act[1102]
- the RE's compliance with its obligations in operating the scheme, including:
  - the pricing of units in the scheme, both when the units are being issued to investors and when investors apply to have their units redeemed.[1103] Proper pricing of units is an important element of the RE's duty to 'treat the members who hold interests of the same class equally and members who hold interests of different classes fairly'[1104]
  - the measurement of a scheme's investment performance[1105]
  - the determination of entitlements of the RE, as well as the entitlements of others (for instance, the entitlement of members to distributions) under the scheme constitution[1106]
  - the determination of other expenses payable from scheme assets.[1107]

1102 Part 2M.3. See also International Organization of Securities Commissions, *Principles for the Valuation of Collective Investment Schemes* (Final Report May 2013) at 4, FSC Standard No. 9, cl 6.1.4.

1103 Joint ASIC and APRA guide *Unit pricing: Guide to good practice* (2008) (ASIC RG 94), International Organization of Securities Commissions, *Principles for the Valuation of Collective Investment Schemes* (Final Report May 2013) at 1, FSC Standard No. 9 *Valuation of Scheme Assets and Liabilities* (2006) cll 5.2, 6.1.1, 6.1.2, FSC Standard No. 8 *Scheme Pricing* (2006), cl 6.1.2. The ALRC/CASAC report (at para 6.11) observed that:

> 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.

FSC Standard No. 9 cl 6.1.4 considers that the primary purpose of determining scheme prices is to maintain equity between existing, ongoing scheme investors and potential and exiting investors.

1104 s 601FC.

1105 International Organization of Securities Commissions, *Principles for the Valuation of Collective Investment Schemes* (Final Report May 2013) at 4, FSC Standard No. 9 at cl 6.1.1.

1106 International Organization of Securities Commissions, *Principles for the Valuation of Collective Investment Schemes* (Final Report May 2013) at 4, FSC Standard No. 9, cl 6.1.3, ASIC/APRA, *Unit pricing: Guide to good practice* (2008) (ASIC Regulatory Guide 94) (RG 94) at 58.

1107 ibid.

There are different valuation requirements for each of these purposes. Financial reports must comply with the accounting standards.[1108] By contrast, the scheme constitution and Product Disclosure Statement may set out the valuation principles to be applied in meeting compliance obligations: these principles may differ from those in the accounting standards (though in practice the valuation principles adopted in the accounting standards are also used in most instances for compliance purposes).

Valuations also provide relevant information when scheme takeovers and mergers are being contemplated.

The issue is whether the current regulatory framework for the valuation of scheme assets is appropriate and, if not, whether there should be a consistent approach for all purposes.

Current position

Corporations Act

Financial reporting

The annual report of a registered scheme must include details of the value of the scheme's assets at the end of the financial year and the basis for the valuation.[1109] Asset values contained in the financial report must be determined in accordance with the accounting standards.[1110]

Compliance

One of the duties of the RE is to ensure that scheme property is valued at regular intervals appropriate to the nature of the property.[1111] This duty is complemented by the requirement for the scheme's compliance plan to set out the arrangements for ensuring that the scheme property is valued at regular intervals appropriate to the nature of the property.[1112]

A scheme constitution would normally contain a provision that specifies how units are to be valued on withdrawal, though such a provision is not required by the Corporations Act. Valuation of scheme property for unit pricing purposes would, however, have to be conducted in accordance with the Corporations Act requirement for the RE to treat scheme members who hold interests of the same class equally and members who hold interests of different classes fairly.[1113]

Accounting standards

The accounting standards govern financial reporting.[1114]

Various accounting standards may also be relevant to the valuation of scheme property for compliance purposes (in particular for unit pricing), depending on the particular type of property being valued. For instance, there are specific standards applicable to:

- financial instruments[1115]

1108 s 296.
1109 s 300(13)(e). This requirement is based on a recommendation in the ALRC/CASAC report, para 6.15.
1110 s 296. See also International Organization of Securities Commissions, *Principles for the Valuation of Collective Investment Schemes* (Final Report May 2013) at 4, FSC Standard No. 9, cl 6.1.4.
1111 s 601FC(1)(j).
1112 s 601HA(1)(c).
1113 s 601FC(1)(d).
1114 s 296.

- property, plant and equipment[1116]
- investment property.[1117]

Other standards might be applicable, depending on the nature of the assets held (for instance, non-current assets,[1118] intangible assets[1119] or agricultural assets.[1120] There is also a standard on fair value measurement, which applies where an accounting standard requires, or permits, an asset to be measured at fair value or at a measure based on fair value.[1121]

Liabilities are also measured in accordance with the accounting standards.

ASIC guidance

RG 132

ASIC Regulatory Guide 132 *Managed investments: Compliance plans* (RG 132) gives guidance on what a compliance plan might contain to deal with the valuation requirement in the Corporations Act. It suggests that a compliance plan should set out:

- how the RE ensures that scheme property is valued at regular intervals appropriate to the nature of the property
- how the RE ensures that scheme property is valued in a manner appropriate to the nature of the property
- the system used for calculating unit price, including:

1115 AASB 132 *Financial Instruments: Presentation*, AASB 139 *Financial Instruments: Recognition and Measurement* (which provides the requirements for each measurement category of financial instruments: see paras 43-49 and AG64-AG82), AASB 9 *Financial Instruments* (see paras 5.1-5.2.3; AASB 9 will supersede the requirements in AASB 139 from 1 January 2015 though entities may elect to adopt it earlier).

1116 AASB 116 *Property, Plant and Equipment*. Property, plant and equipment (PP&E) is to be measured at cost at initial recognition (para 15). The cost of an item of PP&E includes its purchase price plus any additional costs that are directly attributable to the asset and are incurred in bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Paragraphs 16-22 describe the elements of cost. After initial recognition of PP&E, an entity may elect to use either the cost model or the revaluation model. The cost model is the cost of the asset less any accumulated depreciation and impairment losses. The revaluation model (described in paras 31-42) requires an asset to be remeasured periodically at fair value. The carrying amount is the fair value at the date of revaluation less accumulated depreciation and impairment losses.

1117 AASB 140 *Investment Property*. An investment property is defined for accounting purposes as property (land, buildings or both) held to earn rentals or for capital appreciation or both (para 5). Investment property is to be measured at cost at initial recognition (para 20). After initial recognition, an entity may elect to apply either the cost model or the fair value model. However, where an investment property is held by a lessee under an operating lease, the lessor must apply the fair value model to value the property in the financial statements (para 34). The cost model (as per AASB 116) is generally to be applied if an entity chooses that model to account for investment property (para 56). Under the fair value model, the investment property's carrying amount is its fair value. Paragraphs 20-56 provide more detailed requirements.

1118 AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*.

1119 AASB 138 *Intangible Assets*.

1120 AASB 141 *Agriculture*.

1121 AASB 13 *Fair Value Measurement*, applicable to annual reporting periods that begin on or after 1 January 2013, defines fair value (at para 9) as: 'The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.' AASB 13 discusses valuation techniques at paras 61-66, Appendix B paras B5-B30. The valuation techniques discussed are the market approach, the cost approach and the income approach. The income approach includes present value techniques, option pricing models and the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.

  - the controls to ensure that this system is functioning consistently with the scheme's offering document, that the offering document is consistent with the scheme's constitution and that supporting systems (such as the system for processing unit buying and selling activities) are adequately operated
  - the procedures to correct pricing errors
- the controls to ensure that the RE becomes aware of changes in security values and positions on a timely basis so that changes in valuations, income accruals and positions can be evaluated.[1122]

RG 132 also suggests that the compliance plan for a property trust should contain procedures to ensure that the valuation methodologies and frequencies are appropriate.[1123]

RG 94

ASIC has published, jointly with APRA, Regulatory Guide 94 *Unit pricing: Guide to good practice* (2008) (RG 94), which contains a guide to good practice in determining asset values for the purpose of pricing units in a scheme.[1124]

RG 94 emphasises that the RE is responsible for its valuation policies, even if it outsources some aspects of the unit pricing function.[1125]

RG 94 requires those responsible for providing financial products (including interests in managed investment schemes), when preparing valuations:

- to document and explain their valuation methodologies and assumptions and why they are reasonable and appropriate for the assets
- to ensure that valuations are unbiased, with the issuer of the managed investment interests[1126] exercising no undue influence on the determination of asset values
- to monitor and report internally on their valuation procedures
- to review and update their asset valuation policies and procedures (including those relating to estimation) periodically and as market conditions change (with expert professional valuation advice where necessary)
- not to use estimates where actual values are available
- to develop any estimates on a sound and reasonable basis and to be able to justify why an estimate is appropriate in the circumstances.[1127]

RG 134

Regulatory Guide 134 *Managed investments: Constitutions* contains various guidelines and requirements relating to the manner in which a scheme constitution should deal with questions of valuation, including:

1122 at 10, 16. See also at 15 for the calculation of unit price.
1123 at 12 (item 7(i)).
1124 Section 5.1.
1125 at 57.
1126 Referred to in RG 94 as the 'product provider'. Those responsible for providing interests in managed investment schemes may include the RE of the scheme (see at 27).
1127 at 57-59. Estimates are also discussed at 61.

- the valuation of scheme assets for the purpose of setting the consideration to acquire an interest in an unlisted unitised scheme should take into account transaction costs involved in the acquisition and/or disposal of scheme assets[1128]

- the market price can be used to determine the value of interests in listed schemes provided the market value that is used is reasonably current[1129]

- if a listed scheme has a class of interests on issue that is not quoted, the consideration to acquire an interest in that class should be priced using a formula or method based on the value of scheme property less any liabilities that may be met from scheme property referable to that class divided by the number of interests in that class on issue[1130]

- an RE's method for calculating the value of scheme property in the exercise of a discretion must be consistent with the range of ordinary commercial practice for valuing that type of scheme property and produce a value that is reasonably current at the time of issue or withdrawal.[1131] What is 'reasonably current' depends on the nature of the asset, but would generally require a figure:

  - calculated on a daily basis where the financial products held are traded on a market with regular daily transactions

  - as determined within the last year, or such longer period as the RE determines if a current valuation would not be materially different where the assets held are illiquid or thinly traded[1132]

- an RE's method for calculating the value of the market price of interests quoted on a financial market in the exercise of a discretion must be consistent with the ordinary commercial practice for determining the market price of interests of the same kind and produce a market price that is reasonably current at the time of issue or withdrawal.[1133] What is a 'reasonably current' market price depends on the nature of the asset, but would generally be the price or an average price close to the time an issue or an impending issue is announced[1134]

- a withdrawal price must be determined on the basis of valuations of scheme property that are consistent with the range of ordinary commercial practice for valuing the particular type of scheme property and are reasonably current[1135]

- if consideration for a withdrawal may be paid *in specie*, the constitution should provide that the valuations of relevant assets should be consistent with the range of ordinary commercial practice for valuing assets of that type and be reasonably current, as the valuations affect the amount to which a member is entitled on withdrawal and the value of the remaining assets.[1136]

1128 RG 134.44-RG 134.51.
1129 RG 134.59-RG 134.60.
1130 RG 134.62.
1131 RG 134.108.
1132 RG 134.110(b).
1133 RG 134.109.
1134 RG 134.110(a).
1135 RG 134.176.
1136 RG 134.178.

Report 291

ASIC Report 291 *Custodial and depository services in Australia* (July 2012) observed that valuation is the responsibility of the RE: custodians do not generally question reasonable looking valuations before using them in the calculation of unit prices.[1137]

In that report, ASIC identified challenges in relation to valuations and unit pricing generally, including where the assets:

- are illiquid or otherwise infrequently valued, or
- in the case of shares in companies or units in other schemes that form part of scheme property - are not quoted on a financial market or are suspended from trading.[1138]

Financial reporting

In addition to the formal guidance concerning valuation in the context of compliance, ASIC has announced findings from a recent review of financial reports of listed and other public interest entities (including managed investment schemes). These findings indicate areas to which the preparers of financial reports might have regard, including:

- the recoverability of the carrying values of assets, including goodwill, other intangibles, investment properties and property, plant and equipment
- the need for reasonable and supportable cash flows and assumptions in determining recoverable amounts, having regard to such matters as historical cash flows, the manner in which an entity is funded and market conditions
- the need to give adequate weight to matters that might impair the value of assets, such as obsolescence.[1139]

ASIC also drew attention to the need to provide disclosure of certain matters that are important to investors and other users of financial reports, given their subjectivity, including:

- key assumptions including discount rates and growth rates
- periods covered by forecasts.[1140]

Financial Services Council Standard

The Financial Services Council has issued FSC Standard No. 9 *Valuation of Scheme Assets and Liabilities* (2006) (the Standard), to be applied by its members, including those who are the RE of a scheme.

The Standard requires that scheme assets and liabilities be valued at least as frequently as interests in the scheme may be traded, except where the RE considers it to be in the best interests of investors to initiate less frequent valuations.[1141]

1137 ASIC Report 291 *Custodial and depository services in Australia* (July 2012), paras 122-123. See also PJC Trio report paras 5.61, 7.38-7.39, 9.22.

1138 ASIC Report 291, para 124.

1139 Media Release 13-341MR, 'Findings from 30 June 2013 financial reports' (16 December 2013). The ASIC review covered 280 listed and other public interest entities.

1140 ibid. ASIC observed that '[d]isclosure of these matters enables users to make their own assessments about the carrying values of the entity's assets and risk of impairment given the estimation uncertainty associated with many asset valuations'.

Where the formal valuation of certain assets and liabilities is at extended, infrequent intervals:

- valuation policies (including the staggering of formal valuations) must be developed to limit the occurrence of sudden significant increases or decreases in net asset value that do not reflect a true sudden increase or decrease in the underlying value of assets and liabilities[1142]

- consideration should be given to reflecting estimated movements or general market movements between formal valuations[1143]

- the value of assets and liabilities that by their nature are subject to formal valuation at infrequent intervals (for instance, real property, infrastructure, private equity) must be determined at least annually as a minimum.[1144]

The Standard specifies that the RE must 'unless it is inappropriate'[1145] obtain a valuation from 'a reputable, independent third party (such as a professional valuer or tax agent)' where there is no properly regulated market for the assets to be valued.[1146] The RE must provide the professional valuer with all the information the valuer may require to complete the valuation (including the purpose of the valuation, the basis on which the valuation is to be determined, any legislative requirements and requirements of the scheme's constitution and/or Product Disclosure Statement).[1147]

The Standard requires that the processes of valuing scheme assets and liabilities be documented and transparent, unbiased and equitable,[1148] applied consistently and reviewed regularly.[1149] The Standard, while not prescribing a valuation methodology, requires that:

- the methodologies and assumptions used in valuing scheme assets and liabilities be documented and explained[1150]

- the valuation of a scheme's assets and liabilities be based on the market value of all assets and liabilities[1151] unless the market price is deemed to be unreliable (for instance, where trading is infrequent or the market is thin) or no market price is available, in which case the RE must adopt a valuation in good faith, taking into account all relevant factors and clearly documenting any exceptions to documented policies and methodologies[1152]

1141 cl 12.5.
1142 cll 12.6, 12.6.1, 12.6.3.
1143 cll 12.6.1, 12.6.3.
1144 cl 12.6.2.
1145 Items that the standard identifies as inappropriate for a third party valuation, notwithstanding the absence of a properly regulated market, are interests in other schemes managed by the RE or by another RE, outstanding settlements, provision for tax, performance fees, and the RE's fees (cl 11.4.3). For these items, the RE's valuations must be based on sound and justifiable policies that seek to achieve equity between investors, are clearly documented and are regularly reviewed.
1146 cl 11.4.
1147 cll 11.4.1, 11.4.2.
1148 A valuation must be objective, not subject to undue influence by the RE or an associate of the RE and independently verifiable (cl 11.5)
1149 cl 9.1.
1150 cl 10.2.
1151 cl 11.1. The market price to be used in any valuation must be the most recent that can reasonably be obtained (cl 11.3.2).
1152 cll 11.3, 11.3.3, 11.5.3.

- valuations of assets and liabilities traded on a properly regulated market (such as a recognised stock exchange) generally be based on the market price[1153]

- assets and liabilities be valued on a 'going concern' basis, unless this assumption is clearly inappropriate (for instance, if the scheme is in the process of being wound up).[1154]

Valuation processes must be carried out in accordance with applicable Australian Accounting Standards and generally accepted accounting principles.[1155]

The Standard recommends that the valuation provisions of scheme constitutions be brought into line with its requirements,[1156] which apply where their application is of material consequence.[1157]

IOSCO

The International Organization of Securities Commissions, in its Final Report *Principles for the Valuation of Collective Investment Schemes* (May 2013), put forward the following principles:

- *Principle 1:* The Responsible Entity should establish comprehensive, documented policies and procedures to govern the valuation of assets held or employed by a [scheme]

- *Principle 2:* The policies and procedures should identify the methodologies that will be used for valuing each type of asset held or employed by the [scheme].

  The commentary on this principle indicates that:

  – valuations should be determined in good faith

  – where possible, assets should be valued according to current market prices, provided that those prices are available, reliable and frequently updated

- *Principle 3:* The valuation policies and procedures should seek to address conflicts of interest.

  The commentary on this principle points out that conflicts may particularly arise with complex or illiquid assets that are hard to value, for which the scheme operator may be the most reliable or only source of information. The commentary suggests various ways to deal with these conflicts, including internal reviews that are independent of the portfolio management function, a conflict of interest policy and an independent pricing service

- *Principle 4:* The assets held or employed by [a scheme] should be consistently valued according to the policies and procedures

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1153 cl 11.3. Where an asset is traded on more than one properly regulated market, the RE must value the asset on the basis of the primary market for the asset (cl 11.3.1).
1154 cll 12.3, 12.3.2.
1155 cll 5.4, 11.5.3, 12.1.1. See the discussion under **Accounting standards**, above.
1156 cl 6.2.1.
1157 Section 7.

- *Principle 5:* A Responsible Entity should have policies and procedures in place that seek to detect, prevent, and correct pricing errors.[1158] Pricing errors that result in a material harm to [scheme] investors should be addressed promptly, and investors fully compensated

- *Principle 6:* The Responsible Entity should provide for the periodic review of the valuation policies and procedures to seek to ensure their continued appropriateness and effective implementation. A third party should review the [scheme] valuation process at least annually

- *Principle 7:* The Responsible Entity should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services

  The commentary on this principle points out that the RE retains responsibility and liability for valuations, notwithstanding the use of a third party

- *Principle 8:* The Responsible Entity should seek to ensure that arrangements in place for the valuation of the assets in the [scheme]'s portfolio are disclosed appropriately to investors in the [scheme] offering documents or otherwise made transparent to investors

- *Principle 9:* The purchase and redemption of [scheme] interests generally should not be effected at historic NAV [net asset value].

  Historical pricing is 'the pricing method whereby investors purchase or redeem units/shares based on the last calculated NAV' of the scheme.[1159] The commentary on this principle favours forward pricing, which is 'the practice of effecting purchasing and redemption of [scheme] interests at the next computed NAV after receipt of the order', as it 'ensures that incoming, continuing and outgoing investors are treated equitably'

- *Principle 10:* A [scheme]'s portfolio should be valued on any day that [scheme] units are purchased or redeemed

- *Principle 11:* A [scheme]'s NAV should be available to investors at no fee.

IOSCO has also stipulated that regulatory systems should require disclosure of matters material to the valuation of a scheme, including the methodology of asset valuation.[1160]

Analysis and discussion

Some purposes of valuation of assets are the same for companies and for schemes, for instance the requirement to comply with accounting standards in the preparation of financial statements.

However, valuations play a more central role for schemes than for companies, particularly in the pricing of interests. Par value for shares was abolished in 1998.[1161] By contrast,

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1158 The commentary on Principle 5 points out that pricing errors can occur for a number of reasons, including incorrect accrual of fees, late reporting of trades in assets or simple human error in inputting data.

1159 Commentary on Principle 9.

1160 IOSCO *Objectives and Principles of Securities Regulation* (June 2010), *Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (September 2011), Key Questions 1 and 5(e) on Principle 26.

1161 By the *Company Law Review Act 1998*, which came into effect on 1 July 1998.

valuation of the assets of a scheme is the key element in the pricing of scheme interests. Accurate and soundly based valuations, determined on a basis that is fair and equitable to all investors, help ensure that scheme investors in the same class are treated equally (and investors in different classes are treated fairly) in the determination of entry and exit prices and voting entitlements.

Valuation issues are relevant for listed as well as unlisted schemes. For instance, the integrity of the valuation process is directly relevant for determining unit prices in unlisted schemes, as issue and redemption prices for those schemes are calculated on the basis of the value of scheme assets. Valuation is indirectly relevant for listed schemes, as the quoted market price for interests in those schemes incorporates the information in their financial statements, which in turn depends on asset valuations.

Currently, there are different methods of conducting valuations of scheme property for compliance purposes, in particular unit pricing. These various methods may produce different values for particular property: a valuation based on the accounting standards may differ from a valuation prepared on some other basis (for instance, the present value of deferred tax balances may be reflected in a valuation for the purpose of unit pricing, but not in one prepared in accordance with the accounting standards).

A regulatory framework that would promote consistency and comparability in scheme valuations seems desirable to assist investors to understand their investment.

Type of valuation framework

Possible approaches to the development of a uniform valuation framework for compliance purposes (in particular unit pricing) could include one, or a combination, of the following:

- statutory provisions imposing the appropriate requirements (a statutory approach). This option could provide for departure from the statutory requirements, provided that the reasons for the departure were disclosed (an 'if not why not' approach). The option would include a statutory requirement to apply the accounting standards

- a principles–based approach such as that provided by IOSCO. A variation of this option might be a principles-based approach that permitted departure from the principles on an 'if not why not' basis

- a requirement that a scheme's compliance plan[1162] or risk management system contain governance provisions setting out the RE's approach to various aspects of the valuation procedure (a self-regulatory approach:[1163] see Section 5.6 for a discussion of whether the governance framework for schemes should continue to be focused on compliance or, alternatively, should be centred more on risk management). Under this approach, the RE might be required to document and explain its valuation methodologies and assumptions, and its policy on internal and external valuation, and why these elements are reasonable and appropriate for the assets[1164]

1162 Currently, the scheme's compliance plan must include adequate arrangements relating to ensuring that the scheme property is valued at regular intervals appropriate to the nature of the property (s 601HA(1)(c)).

1163 This approach is described as self-regulatory, despite the fact that the requirement to have these corporate governance provisions is imposed by legislation, as the content of the provisions would be determined by the RE.

1164 Joint ASIC and APRA guide *Unit pricing: Guide to good practice* (2008) (ASIC RG 94) at 57.

- reliance on existing or new guidelines from ASIC[1165] or industry bodies (a best practice approach). For instance, ASIC could issue guidance on valuation that could incorporate, but go beyond, the relevant guidance on valuation in its guidance on compliance plans (RG 132) and unit pricing (RG 94). Guidelines under this option may provide for departure from the guidance on an 'if not why not' basis.

The valuation framework might:

- relate to the valuation of specific types of scheme asset so that all assets of the same type would be valued on the same basis, regardless of the type of scheme in which the asset is held. This would ensure a level of consistency and comparability

- apply to the valuation of scheme property generally within a scheme (for instance, the framework might provide either that the valuation methodology adopted for a scheme must be one that is commonly accepted in the market for that asset or that there should be an indication of what methodology has been adopted, with an explanation of how it departs from commonly accepted valuation methodologies).

The framework should ensure that any valuation requirements or guidelines are appropriate not just for the particular asset being valued, but for the particular scheme and its investors. For instance, ASIC draft guidance on risk management for REs suggests that a scheme's valuation policies take into consideration such factors as the type of assets in which the scheme invests and the operating model of the scheme (for instance, whether it allows off-market issue and redemption of interests).[1166] Retail investors might require information that differs from that required by wholesale investors, both in content and in presentation.

Responsibility for valuation

Currently, it is the duty of the RE to ensure that scheme property is valued at regular intervals.[1167] If a statutory approach is maintained, an issue is whether it is appropriate for a valuation requirement to be cast as a specific duty of the RE.

It is a common practice for REs to outsource valuations of scheme property to third parties. Issues that arise in relation to choosing an external valuer are:

- what qualifications the valuer should possess (for instance, membership of an appropriate professional body for valuations)

- how to ensure that the valuer is independent of the RE and the RE's associates and has no other conflict of interest (for instance, the valuer might be required to sign a declaration to this effect)

- whether the valuer should be prohibited from performing more than a certain number of consecutive valuations.[1168]

[1165] For instance, RG 94 (at 56) identifies as one of the asset valuation issues 'developing, documenting and implementing valuation policies for the range of assets held in the fund'.

[1166] ASIC Consultation Paper 204 *Risk management systems of responsible entities* (March 2013), Appendix to draft Regulatory Guide 000 at p 57 of the Consultation Paper.

[1167] s 601FC(1)(j).

[1168] For instance, ASIC Consultation Paper 204 *Risk management systems of responsible entities* (March 2013) suggests rotation of valuers as a means of treating the investment risk arising from valuation and pricing issues (Appendix to draft Regulatory Guide 000 at p 57 of the Consultation Paper).

Another issue is whether a regulatory framework should specify any circumstances in which, or any particular types of property for which, an RE should be required to engage an external valuer and, if so, what governance arrangements should apply to that engagement. These arrangements could include such matters as:

- documentation that the external valuer should provide to the RE to explain its valuation methodology (for instance, the key inputs and assumptions used in the methodology)
- whether the RE should disclose any such documentation to scheme members and in what circumstances
- requiring the RE to check the assumptions being made by the external valuer, to determine if they are appropriate for the scheme and the industry in which it operates
- other ongoing arrangements for the RE to monitor the external valuer
- a valuation committee or another committee, such as a compliance or an audit committee, to assist in performing the monitoring role
- arrangements for communication between such a committee and the RE.

One reason for REs to outsource valuation might be the possibility of conflict of interest where an RE values the portfolio that it is managing.

Methodology for valuing assets for compliance purposes

Valuation methodologies differ, depending on the particular type of asset being valued and the time of valuation.[1169] For instance, the value of certain structured financial instruments and OTC derivatives cannot be determined by using quoted prices: their valuation requires the use of internal techniques that rely on management's judgment.[1170] Similarly, there are recognised methodologies for determining the values of some assets that are not traded in deep, liquid and well-maintained markets, such as property and infrastructure.[1171] These methodologies are applied with varying frequency, depending on market conditions and the professional judgement of investment managers and valuers.[1172] Particular valuation issues also arise for assets that are traded only infrequently (thinly traded assets, for instance rarely traded shares) and illiquid assets such as some hedge funds and some types of private equity.[1173] Valuations of more complex assets may require specific skills and systems and particular personnel who have an appropriate level of knowledge, experience

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1169 See International Organization of Securities Commissions, in its Final Report *Principles for the Valuation of Collective Investment Schemes* (May 2013) Principle 2 and the accompanying commentary.

1170 International Organization of Securities Commissions, *Principles for the Valuation of Collective Investment Schemes* (Final Report May 2013) at 1.

1171 See the fourth asset valuation issue on p 56 of RG 94.

1172 ibid. In other instances, the methodologies for valuing assets that are not traded in deep, liquid and well-maintained markets are less well recognised or are specific to a transaction (for instance, some types of complex structured products and some types of OTC derivative): see the fifth asset valuation issue at 56; see also at 58 under the heading **Valuation of non-exchange traded assets**. In those cases, values may be determined by applying a model, by periodic third party valuation or by using an estimate between specific valuation dates.

1173 id, sixth and seventh asset valuation issues at 56. See also at 61. The commentary on Principle 2 in the International Organization of Securities Commissions Final Report *Principles for the Valuation of Collective Investment Schemes* (May 2013) points out that '[t]he more illiquid such markets are, the more robust the valuation process may need to be'.

and training.[1174] Where assets are valued infrequently, it is not uncommon for an interim valuation to be conducted on the basis of the manager's professional judgement.

Where the professional judgement of the RE is used to determine a valuation, there is an issue whether rules or principles should be established to ensure the consistency and quality of any resulting valuation. There is also a question whether it should be mandatory to disclose that a valuation is the result of management's professional judgement, rather than the result of a professional external valuation.

Where external valuations are carried out, there is an issue whether the RE should be permitted to give the external valuer instructions on how the valuer should carry out the valuation and, if so, whether the RE should be required to have a written policy that forms the basis of any such instructions.

There is also an issue about the weight that should be given to the standards of any relevant professional body of which the valuer is a member. The valuer might be required to apply these standards and state that this is the case. Alternatively, the valuer could be permitted to depart from those standards, but required to explain any such departure (an 'if not why not' approach).

Given the diversity of valuation methodologies, persons who have responsibility for scheme valuations should be required to document and explain their valuation methodologies and assumptions and why they consider that those methodologies and assumptions are reasonable and appropriate for the assets being valued. As discussed under ***Responsibility for valuation***, the person with this responsibility may be an external valuer.

There is a question about to whom this information should be disclosed, given that it may be commercially sensitive. Possible parties to whom information might be disclosed are:

- scheme members
- prospective scheme members (who would be interested in the rate of return they might expect from investing in the scheme)
- the scheme auditor.

Frequency of valuation

Currently, REs have a duty 'to ensure that scheme property is valued at regular intervals appropriate to the nature of the property'.[1175] There is a question whether this duty is an appropriate way to ensure that scheme property is valued sufficiently frequently. Regularity of valuations does not necessarily ensure that they are valued at appropriate intervals to provide the required information about scheme assets in a timely fashion or that the valuation provides an appropriate measure of the value of that asset at the date of the valuation.[1176]

[1174] International Organization of Securities Commissions, in its Final Report *Principles for the Valuation of Collective Investment Schemes* (May 2013) Principle 2 and the accompanying commentary.

[1175] s 601FC(1)(j).

[1176] ASIC Consultation Paper 204 *Risk management systems of responsible entities* (March 2013) states in the Appendix to draft Regulatory Guide 000 at p 57 of the Consultation Paper:

As with the valuation methodology, the intervals at which an asset should be valued to provide an appropriate value for specific circumstances can differ depending on the type of assets being valued. Some asset values change rapidly and valuation of those assets may need to be carried out daily. For instance, in the case of a scheme involving securities quoted on an exchange, the RE (or its agent) will generally obtain daily price feeds from the exchange for these securities.[1177] Some REs may even value scheme assets more than once a day if their systems have the necessary capacity.[1178] Other assets, such as real property and infrastructure, by their nature are valued only at longer intervals.[1179] Where more than one of these assets is held in a portfolio, periodic valuations should occur at different times, where possible.[1180]

In addition to the type of assets, frequency of valuations might be affected by the nature of the particular scheme. For instance, withdrawals from a particular scheme might only be permissible every five years. For such a scheme, valuation might only be required around the time of withdrawal, even though individual assets within the scheme might be valued more frequently (for instance, annually) for financial reporting or compliance purposes.

These different time horizons for valuation may influence whether the valuation is conducted internally or externally. Where an asset value is required between formal valuations (for instance, to strike a unit price), an RE may only need an estimate of the value of the asset.[1181] Where a valuation is needed frequently, the RE may perform an internal 'desktop' valuation of the relevant asset or assets, with external valuations of those assets being performed at longer intervals such as every year or two years.

Given these differences in the appropriate frequency of valuation, general requirements relating to this matter may be preferable to a specific rule, for instance:

- a requirement that valuation of scheme assets occur reasonably frequently, taking into account the nature of each asset being valued, and in accordance with the ordinary commercial practice for that asset

- a requirement that scheme assets be valued before certain key events in the conduct of the scheme's business that depend on the scheme's asset values, for instance:

  - the determination of the price for the redemption or issue of units in the scheme[1182]

  - the determination of the RE's fees or the preparation of the annual accounts.

- At the scheme level, there is a risk of scheme assets not having a correct valuation on a timely basis. While this risk may not be relevant to some registered schemes (e.g. timeshare schemes, property syndicates or forestry schemes), robust valuation practices are essential for effective liquidity risk management and correct pricing of interests in most registered schemes.
- This risk generally is higher for schemes that invest in assets that are not traded on a financial market or assets that do not have a liquid market (e.g. mortgage or property schemes) where transparent price setting for scheme assets is more difficult to facilitate.

1177 ASIC Regulatory Guide 132 *Managed investments: Compliance plans* at 16.

1178 FSC Standard No. 9, cl 12.5.1.

1179 FSC Standard No. 9, cl 12.6.2 (which points out that infrequent valuation may also partly be the result of the costs of obtaining a valuation). RG 94 (at 60) requires that valuations for infrastructure, which has a recognised valuation methodology, be obtained periodically from reputable, professional, third party valuers.

1180 RG 94 at 60, FSC Standard No. 9 at cl 12.6.1.

1181 These 'soft prices' are estimated as a part of normal business operations when actual or hard prices are obtainable, but not at the relevant time. These soft prices may be based, for instance, on index or other market movements. See further RG 94 at 56, 59-60.

1182 Cf the second asset valuation issue on p 56 of RG 94. See also at 59 under the headings **Frequency of transacting and frequency of unit pricing** and **Frequency of unit pricing and frequency of asset valuation**.

One issue under the latter approach would be how close to the date of the key event the valuation should be done and whether this question should be decided differently for different types of asset (for instance, the valuation of shares would change much more frequently than that of real property).

Question 15.1.1. Should a scheme's valuation procedures be limited to those required by the accounting standards, regardless of the purpose of the valuation?

Question 15.1.2. If the answer to Question 15.1.1 is no, should additional regulations and guidance be introduced to ensure consistency in the valuation of scheme assets for specific purposes (other than for the preparation of financial statements) such as unit pricing?

Question 15.1.3. If the answer to Question 15.1.2 is yes, for which specific purposes and should the regulatory framework be contained in:

- legislation (a statutory approach)
- a principles–based approach
- a scheme's compliance or risk management framework (a self-regulatory approach)
- existing or new ASIC or industry guidelines (a best practice approach)
- some combination of these approaches?

Question 15.1.4. Should any valuation framework:

- include valuation requirements for specific types of scheme asset, regardless of the type of scheme that holds such assets
- be sufficiently flexible to take into account the nature of particular schemes and the particular types of investors in a scheme
- apply to the valuation of scheme property generally within a scheme, so that different schemes can have different valuation frameworks but each scheme must adopt a consistent approach
- distinguish between liquid and non-liquid schemes?

Responsibility for valuation

Question 15.1.5. Should valuation of scheme assets be a specific duty of the RE?

Question 15.1.6. Where an RE outsources valuation of scheme assets:

- how should the regulatory framework provide for the selection and terms of reference of the external valuer
- how should the regulatory framework ensure that the external valuer is independent of the RE and the RE's associates and has no other conflict of interest
- should the RE be permitted to give the external valuer instructions on valuation procedure and, if so, should the RE be required to have a written policy that forms the basis of any such instructions
- what, if any, restrictions should there be on the number of consecutive valuations performed by the external valuer
- what governance arrangements should apply to the engagement of the external valuer (for instance, documentation to explain the valuation methodology, arrangements for the RE to check the valuer's assumptions or otherwise monitor the valuer, including with the assistance of a committee)

- what weight should be given to the standards of any relevant professional body of which the valuer is a member?

Question 15.1.7. Should there be a specific requirement for the external valuation of assets:

- in particular circumstances and, if so, what
- for particular types of asset and, if so, what (for instance, real property)?

Methodology of valuation for compliance purposes

Question 15.1.8. Should persons with responsibility for scheme valuations be required to:

- document and explain their valuation methodologies and assumptions, and
- explain why they consider that those methodologies and assumptions are reasonable and appropriate for the assets being valued?

Question 15.1.9. If so, to whom should that information be given?

Question 15.1.10. Where the professional judgement of the RE is used to determine a valuation, should rules or principles be established to ensure that any resulting valuation meets certain quality standards and is consistent with similar valuations?

Question 15.1.11. Where a valuation relies on the professional judgement of the RE, rather than a professional external valuer, should this be disclosed and to whom?

Question 15.1.12. Should there be any other form of regulation of the methodology for valuing scheme assets and, if so, what?

Frequency of external valuations

Question 15.1.13. What requirements should there be for the frequency of external valuation of scheme assets, for instance:

- should there be a flexible requirement for frequency of valuations, based on the nature of the asset being valued and the ordinary commercial practice for valuing that type of asset
- should there be a requirement that scheme assets be valued before certain key events in the scheme's business that depend on current asset values and, if so
- how close to the date of the key event should the valuation be done and would this depend on the type of asset?

15.2 Definition of 'financial market'

The issue

Should the definition of financial market be amended to make it clear that it does not include mechanisms for withdrawing from non-liquid schemes?[1183]

Current position

A 'financial market' is defined as a facility through which:

[1183] The question of distinguishing between liquid and non-liquid schemes is further discussed in Section 9.3 of this paper.

- offers to acquire or dispose of financial products are regularly made or accepted, or
- offers or invitations are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in:
  - the making of offers to acquire or dispose of financial products, or
  - the acceptance of such offers.[1184]

A financial market requires either:

- an Australian market licence, or
- an exemption from the market licensing provisions.[1185]

The obligations of the holder of an Australian market licence include:

- to the extent that it is reasonably practicable to do so, to do all things necessary to ensure that the market is a fair, orderly and transparent market
- to comply with the licence conditions
- to have adequate arrangements for operating the market, including arrangements for handling conflicts between the licensee's commercial interests and the need to ensure that the market is fair, orderly and transparent
- to have sufficient resources (including financial, technological and human resources) to operate the market properly
- to ensure that there are any required compensation arrangements
- to take all reasonable steps to ensure that no disqualified individual becomes, or remains, involved in the licensee.[1186]

Analysis and discussion

The definition of 'financial market' may have caused the REs of some non-liquid schemes not to proceed with some mechanisms that would have allowed members to exit from the scheme by finding a willing counterparty, for fear that to do so would have caused the creation of a 'financial market'.

Possible withdrawal mechanisms that may come within the definition of 'financial market'[1187] include:

1184 s 767A(1).
1185 Part 7.2 Div 2.
1186 s 792A(a)-(e), (i). Other obligations are found in ss 792B-792I. There are also specific requirements for particular types of licensees (s 792A(f)-(h)). See generally ASIC Regulatory Guide 172 *Australian market licences: Australian operators*.
1187 The activities do not come within any of the current exceptions in s 767A(2), which relate to:
- offers or invitations made on a person's own behalf or on behalf of one party to the transaction only (subject to a contrary provision in the regulations)
- treasury operations between related bodies corporate
- auctions of forfeited shares.

- a grey market (being a market for interests in the scheme operated by the RE where only existing members can buy and sell)
- a bulletin board whereby:
  - scheme members can post an indication of their willingness to sell their interests at a certain price
  - potential buyers have access to this information in order to decide whether they want to purchase those interests.

  In theory, a bulletin board is a process where active matching of buyers with sellers does not occur.

If these potential mechanisms came within the definition of 'financial market', persons proposing them would have to develop the regulatory infrastructure required by the financial market licensing system or obtain an exemption.

It may be desirable in certain circumstances to facilitate withdrawals from illiquid funds, especially for retail investors. Equally, however, it is important to maintain protections for investors[1188] when withdrawals are permitted.

It may be difficult to tailor a suitable legislative amendment to the definition of 'financial market' to facilitate withdrawals from these non-liquid schemes.

Question 15.2.1. Does the definition of 'financial market' have inappropriate consequences for the issue and disposal of managed investment products? If so, how might these consequences best be dealt with?

15.3 Exception to the insider trading prohibition

The issues

Should the exception to the insider trading provisions for withdrawal from a registered managed investment scheme be continued and, if so, should it be restricted to the RE of a registered scheme?

Does the test for calculating the withdrawal amount require clarification?

Current position

A person who knowingly possesses inside information about interests in a managed investment scheme is prohibited from dealings in those interests.[1189]

This prohibition does not apply to a member's withdrawal from a registered scheme if:

> the amount paid to the member on withdrawal is calculated (so far as is reasonably practicable) by reference to the underlying value of the assets of the financial or business undertaking or scheme, common enterprise, investment contract or

[1188] Currently contained in Part 5C.6.
[1189] s 1043A, read with the definitions of 'Division 3 financial products', 'relevant Division 3 financial products' and 'inside information' in s 1042A.

> time-sharing scheme to which the member's interest relates, less any reasonable charge for acquiring the member's interest.[1190]

This exception to the insider trading prohibition was part of the original insider trading amendments introduced by the *Corporations Legislation Amendment Act 1991*.[1191] The exception responded to concerns that:

> there may be a conflict between the redemption requirements of a trust manager under a trust deed and the insider trading provisions. Trust deeds must provide redemption facilities under the Corporations Law and in doing so the trust deed may specify that the buy—back price is to be adjusted on a periodic basis to reflect the underlying value of the assets of the trust and that units are to be bought back at the price quoted at the time of the application for redemption. In such circumstances, the buy—back price may not at any given time reflect all material information in the possession of the trust manager and to avoid contravening the insider trading provisions by waiting for the price to reflect all such information the manager may be in breach of the trust deed.[1192]

The Explanatory Memorandum said that the provision containing the exception (originally s 1002H of the Corporations Law):

> provides that the manager of a prescribed interest does not contravene the prohibition in subsection 1002G(2) where it redeems a prescribed interest in accordance with a buy—back covenant, at a price that is required to be calculated, so far as reasonably practicable, by reference to the underlying value of the assets to which the prescribed interest relates less any reasonable charge for purchasing the interest. The provision takes into account lags in adjusting the buy—back price for changes in the underlying value of the assets.[1193]

Analysis and discussion

Although the Explanatory Memorandum states that the manager would not contravene the insider trading prohibition when redeeming interests, the legislation was not in fact stated this way. Instead of a positive exemption for the manager (RE), the legislation stated that the insider trading prohibition does not apply 'in respect of the redemption' of a prescribed interest.[1194] The same legislative approach was taken when the insider trading provisions were amended to recognise the replacement of prescribed interests with managed investments: the exception is now stated as applying 'in respect of a member's withdrawal from a registered scheme'.

This legislative wording makes the exception available for any withdrawal from a scheme, regardless of whether it is the RE or the member who has the inside information. This result departs from the original rationale for the exception, which was to ensure that an RE does not have a conflict between its legislative buy-back obligations[1195] and the insider trading prohibition.

There does not appear to be any policy reason why a member should be entitled to exercise withdrawal rights while in the possession of inside information. It would appear

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1190 s 1043B.
1191 Those amendments were introduced in response to the recommendations in the report of the House of Representatives Standing Committee on Legal and Constitutional Affairs *Fair shares for all: insider trading in Australia* (1989), which recommended that it be made clear that the insider trading provisions apply to prescribed interests (the predecessors to managed investment schemes).
1192 Explanatory Memorandum to the Bill for the *Corporations Legislation Amendment Act 1991*, para 347.
1193 para 348.
1194 Former s 1002H.
1195 Part 5C.6.

reasonable for a member in that position to disclose the information to the RE, to obtain the defence that both parties knew the information before entering into the transaction.[1196] A member who is not able to disclose the information for confidentiality reasons should not be able to trade.

There may also be difficulties in calculating the withdrawal amount under the exception, for instance:

- it is not clear whether the exception can apply where schemes have different classes of interests[1197]
- the meaning of the term 'underlying value of the assets' may not be sufficiently clear or certain.

Question 15.3.1. Should the exception from the insider trading prohibition where a member withdraws from a managed investment scheme be amended and, if so, in what manner?

15.4 Alignment of corporate and scheme law

A key principle underlying CAMAC's views on many of the issues considered in this paper is that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently.[1198] This principle has been raised (both where there seemed to be a prima facie case for aligning the two regimes and where there appeared to be compelling reasons not to do so) in sections of this paper discussing who is a scheme member,[1199] scheme registration,[1200] the governance framework for schemes,[1201] the scheme constitution,[1202] matters relating to directors and officers of the RE,[1203] related party transactions,[1204] scheme meetings,[1205] buy–backs,[1206] disclosure,[1207] reorganization of schemes,[1208] winding up[1209] and the application of the civil penalty regime to schemes.[1210]

[1196] s 1043M(2)(b).

[1197] The terms of the exception make no special provision for schemes with different classes. This may suggest that the test implies a withdrawal amount that will be the same for all interests in the scheme, whether or not they are in the same class. A possible contrary view of the current law is that the exception does not require that the withdrawal amount be calculated *only* 'by reference to' the stipulated asset value, to the exclusion of other relevant factors. On this view, the withdrawal amount could vary for different classes of interests, provided that the calculation of the withdrawal amount for each class is calculated by reference to the stipulated asset value. The exception should ensure that the withdrawal amount is appropriate for the particular interests being bought back. This would be consistent with FSC Standard No. 9 *Valuation of Scheme Assets and Liabilities* (2006) cl 9.1.2, which provides:

> Where a Scheme allows for Investors with different classes of interest, the valuation of Scheme Assets and Liabilities must be fair to each class and in accordance with the Scheme's Constituent Documents and the Corporations Act.

[1198] See Section 1.1.2 of this paper.

[1199] Sections 3.2 and 9.5.

[1200] Sections 4.1 and 4.2.

[1201] Section 5.6.1.

[1202] Sections 6.2 and 6.3.

[1203] Sections 7.4 and 12.4.

[1204] Section 7.5.

[1205] Sections 8.1-8.3, 8.5-8.7.

[1206] Section 9.4.

[1207] Section 10.4.4.

[1208] Section 11.2.

[1209] Section 12.1.

CAMAC invites submissions on whether there are any other areas where alignment of company law and scheme law would be appropriate.

Question 15.4.1. Are there any areas not identified in the other sections of this paper where the law applicable to schemes should be, but is currently not, aligned with that applicable to companies?

[1210] Section 13.2.

16 Minor matters

This chapter discusses various definitions relevant to managed investment schemes. It also examines various administrative, procedural and enforcement issues.

16.1 Definition of 'class of interests' in a managed investment scheme

The issue

The Corporations Act definition of 'class' in relation to interests in a managed investment scheme does not specify what constitutes a 'class'. This matter is determined by general law principles. Litigation may be necessary to determine the application of those principles in particular instances.

Current position

The Corporations Act provides that:

> If the interests in a managed investment scheme to which an undertaking relates are not divided into 2 or more classes, they constitute a class.[1211]

The Act provides no further detail on what might constitute a class of interests in a scheme. However, in the case of companies, the courts have applied the following principles:

- a class 'must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest'.[1212] Another formulation is that a class of shares is 'a category of shares which differs sufficiently in respect of rights, benefits, disabilities, or other incidents, as to make it distinguishable from any other category of shares'[1213]

- members may be in the same class notwithstanding that they may have divergent commercial interests, which are strictly separate from their share membership.[1214]

In addition, the Administrative Appeals Tribunal has said:

> The basis of classification might be as simple as a declaration in the constitution that shares can be issued in two classes, even though there is no practical difference between the two types of share.

1211 s 57(2). The equivalent provision for companies is s 57(1). The definition of 'class' in relation to shares or interests in a managed investment scheme in s 9 refers to this provision.

1212 *Sovereign Life Assurance Company v Dodd* [1892] 2 QB 573 at 583.

1213 *Clements Marshall Consolidated Ltd v ENT Ltd* (1988) 13 ACLR 90 at 93. See also *Felix Resources Pty Ltd; in the matter of Felix Resources Pty Ltd (No 2)* [2009] FCA 1337 at [12].
The Turnbull Report (Section 5.3.1) raised for further consideration and consultation a proposal that would, in effect, define a 'class' of members by amending s 601FC(1)(d) to require that members must be treated equally in relation to interests they have that confer substantially the same right to benefits produced by the scheme and the same obligations, and all members must be treated fairly: class differentiation would be based on the rights attached to an interest, rather than purely on a member's characteristics.

1214 *Felix Resources Pty Ltd; in the matter of Felix Resources Pty Ltd (No 2)* [2009] FCA 1337 at [12].

…

> companies should be permitted the widest possible freedom to structure their affairs to achieve an efficient and attractive capital structure. Managed investment schemes are in the same position.[1215]

Analysis and discussion

It can be important for various purposes to determine whether the interests in a managed investment scheme are divided into different classes. For instance, the RE of a registered scheme, in exercising its powers and carrying out its duties, must treat the members who hold interests of the same class equally and members who hold interests of different classes fairly.[1216] Also, an offer by an RE to withdraw, wholly or partly, from a non-liquid scheme can be made to members of a particular class, rather than to all members of a scheme.[1217]

The potential for litigation to invalidate actions that have been taken on the basis of an incorrect determination of the existence of, or the constitution of, classes poses a risk to commercial activity.

A possible approach would be for the Corporations Act to stipulate circumstances in which classes exist or do not exist. For instance, it might provide that interests would not constitute a different class merely because of a different rate of return or a different investment amount. This approach would leave the courts to develop and apply the general law principles for the determination of classes, but provide some certainty in the specified circumstances.

Another approach would be to give the court an express curative power to validate actions taken on the basis of a view of the class structure of a scheme that subsequently proves to be incorrect.[1218]

Question 16.1.1. Should the Corporations Act specify circumstances in which there are separate classes of interests in a managed investment scheme and, if so, what should those circumstances be?

Question 16.1.2. Should the Corporations Act specify circumstances that should not be taken to give rise to separate classes of interests in a managed investment scheme and, if so, what should those circumstances be?

Question 16.1.3. Should there be an express curative power for the court to review a decision that relied on an incorrect categorization of the classes of interests in the scheme and to validate any actions taken pursuant to that decision?

1215 *Equitiloan Pty Ltd v Australian Securities and Investments Commission* [2003] AATA 367 at [29].
1216 s 601FC(1)(d).
1217 s 601KB(2)(b).
1218 A similar curative power was recommended in the CAMAC report *Members' schemes of arrangement* (2009) (Section 5.4.1).

16.2 Exception from the definition of 'managed investment scheme' for intra-group schemes

The issue

There is an exception from the definition of 'managed investment scheme' for intra-group schemes involving only bodies corporate that are related to the promoter and to each other. The question is whether that exception should apply where other persons have an indirect interest in the scheme.

Current position

The definition of 'managed investment scheme' contains an exception for:

> (e) a scheme in which all the members are bodies corporate that are related to each other and to the body corporate that promotes the scheme.

If the exception applies, the scheme need not be registered.

This exception for intra-group schemes adopted a recommendation in the ALRC/CASAC report, which said:

> 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.[1219]

Analysis and discussion

The Turnbull Report noted an argument by ASIC that 'the intention of [the intra-group] exclusion is undermined if some person unrelated to the scheme promoter indirectly acquires an interest in the scheme'.[1220]

There are various situations in which parties may gain an indirect interest in an intra-group scheme. For instance, beneficiaries of a trust may gain this type of indirect interest where the trustee is a body corporate that is a member of the scheme and invests trust funds in the scheme. Those beneficiaries may be retail investors who would ordinarily have the protection of the managed investment provisions and the licensing regime in the Corporations Act.

The question is whether the rationale for the exception, namely that an intra-group scheme is essentially of a 'private nature', is invalidated if persons who are not related to the promoter or other scheme members have indirect interests in the scheme. The answer may depend on the type of indirect interest involved.

For instance, the potential for some level of indirect involvement in an intra-group scheme is inherent in the concept of a 'related body corporate',[1221] which is the key element of the intra-group exception, and the related concepts of 'holding company'[1222] and

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1219 para 3.20.
1220 Section 5.3.2.
1221 Definition of 'body corporate' in s 9, s 50.
1222 Definition of 'holding company' in s 9, s 46.

'subsidiary'.[1223] For instance, Company A is the 'subsidiary' of Company B if Company B:

- 'is in a position to cast, or control the casting of, more than one-half of the maximum number of votes that might be cast at a general meeting' of Company A,[1224] or
- 'holds more than one-half of the issued share capital' of Company A,[1225] or
- 'controls the composition' of Company A's board[1226] (such control can be achieved without 100% control of a company's shares).

The possible presence of minority shareholders of related bodies corporate who have chosen to be active investors in a risk-taking enterprise is an inherent part of the intra-group exception.

However, if the related body corporate is a trustee, it may be undesirable to expose beneficiaries of the trust or retail clients who acquire an interest under a custodial arrangement to any risks involved in the activities of an unregistered (and hence largely unregulated) scheme.

If some amendment to the exception were thought necessary, one possibility, raised for further consideration by the Turnbull Report,[1227] might be to add words to the following effect at the end of the exception:

> and no members:
>
> - hold an interest on trust except where the only beneficiaries are such bodies corporate: or
> - have acquired their interest as an acquirer under a custodial arrangement as defined in section 1012IA.[1228]

Question 16.2.1. Should the exception from the definition of 'managed investment scheme' for intra-group schemes be amended and, if so, in what way? Please provide reasons for favouring or not favouring an amendment to this exception and for any amendment proposed.

16.3 Application of the definition of 'securities' to interests in schemes

The issue

The Corporations Act contains different definitions of 'securities' for different purposes. The extent to which these definitions cover interests in managed investment schemes varies from definition to definition. The definition that applies to reporting the link between remuneration and performance may not be the most appropriate one.

1223 Definition of 'subsidiary' in s 9, s 46.
1224 s 46(a)(ii).
1225 s 46(a)(iii).
1226 s 46(a)(i).
1227 Section 5.3.2.
1228 Section 10.4.4 of this paper discusses what is involved in a custodial arrangement as defined in s 1012IA.

Current position

The annual directors' reports of listed companies must give an explanation if a grant of securities that constitutes an element of the remuneration of a member of the company's key management personnel does not depend on the satisfaction of a performance condition.[1229] The definition of 'securities' that applies to this requirement[1230] covers interests in a managed investment scheme (primary interests), but does not the following types of secondary interests in schemes:

- legal or equitable rights or interests in those interests
- options to acquire those interests
- options to acquire legal or equitable rights or interests in those interests.

These secondary interests are covered by other definitions of 'securities'.

The various definitions of securities, and the extent to which they apply to primary and secondary interests in managed investment schemes, are set out in Appendix 2 to this paper.

Analysis and discussion

It is not clear why the requirement for the annual report of a listed company to explain the link between remuneration and performance does not cover the grant of secondary interests as well as primary interests in managed investment schemes.

Question 16.3.1. Should the requirement for the annual report of a listed company to explain a grant of primary interests in managed investment schemes that does not depend on performance also apply to secondary interests in a scheme?

Question 16.3.2. Are there any other regulatory provisions in the Corporations Act relating to 'securities' that should, but currently do not, apply to primary and/or secondary interests in managed investment schemes?

16.4 Definition of 'client'

The issue

The financial services provisions in Chapter 7 of the Corporations Act provide various protections for 'clients'. However, it is not clear who is a 'client' in the context of a managed investment scheme.

Current position

There are numerous references to 'clients', particularly retail clients, in the financial services provisions in Parts 7.6 to 7.8 of the Corporations Act, for instance in relation to

[1229] s 300A(1)(d). See also s 300A(1)(ba)(iv)(B).
[1230] s 92(2).

dispute resolution procedures for retail clients,[1231] compensation arrangements for retail clients[1232] and Product Disclosure Statements[1233] for those clients.

The legislation contains provisions that set out the criteria for determining whether a person is a 'retail client' or a 'wholesale client'.[1234] However, it does not define the term 'client'.[1235]

Analysis and discussion

The absence of a definition of 'client' in the Corporations Act gives rise to uncertainty about who is a 'client' and therefore entitled to the investor protections in Chapter 7 of the Corporations Act, including access to compensation arrangements or Product Disclosure Statements. Scheme members can only take advantage of those provisions if they are 'clients'.

While this lack of certainty about who is a 'client' arises in relation to financial products generally, for some products, the legislation contains contextual information that makes it clear who is a 'client'.[1236] However, there is no contextual information that would assist in determining who is a 'client' in relation to a managed investment scheme.

It would be beneficial for the legislation to make clear that the term 'client' includes members of a managed investment scheme, to ensure that they have access to the investor remedies in Chapter 7 of the Corporations Act. This might be achieved by a provision directed solely at clarifying the position in relation to scheme members or, alternatively, by a broader definition of the term 'client' in relation to financial products generally (for instance, that a client is a person to whom a financial product has been issued or sold or to whom advice has been given about a financial product).

Question 16.4.1. Should the Corporations Act make it clear that a member of a managed investment scheme is a 'client' for the purposes of the financial services provisions in Chapter 7 of the Act and, if so, how? In particular, should any clarification relate only to scheme members or be a broader definition of 'client' in relation to financial products generally?

16.5 Definition of 'rights issue'

The issues

The Corporations Act definition of 'rights issue' may unduly disadvantage holders of interests in managed investment schemes who are resident outside Australia and New Zealand.

1231 s 912A(1)(g), (2).
1232 s 912B.
1233 Part 7.9.
1234 ss 761G, 761GA.
1235 The definition of 'client' that appeared in the Corporations Act before the enactment of the *Financial Services Reform Act 2001* related to futures brokers. The FSRA replaced the futures industry provisions of the Corporations Act with the current Chapter 7, which regulates financial services and markets.
1236 For instance, the references to 'client' in the provision describing when financial products are issued (s 761E) make it clear that the term covers a contributor, or the employee of a contributor, to a superannuation fund, a depositor into a retirement savings account, a contributor to a First Home Saver Account, a purchaser of life insurance and a depositor with an authorised deposit–taking institution.

It also does not apply in the case of unregistered schemes, given that it depends on the existence of an RE.

Current position

The definition of 'rights issue' is used in determining whether there is an obligation to give a Product Disclosure Statement.

A 'regulated person' (for instance, an issuer of a financial product, a financial services licensee or an authorised representative of that licensee[1237]) may be relieved of the obligation to give a Product Disclosure Statement where quoted securities are being issued under a rights issue and certain other conditions are met.[1238]

Three criteria must be satisfied for an issue to come within the definition of a 'rights issue'.

Two of the criteria are that:

- the interests being offered for issue are in a particular class, and
- the terms of each offer are the same.[1239]

The other criterion relates to the need to provide all holders of interests in the scheme with an equal opportunity to participate in the benefits of the rights issue to the greatest extent possible. It requires that a pro rata offer be made to each person. However, the RE of the scheme, in effect, has the power to modify this condition if the scheme has members whose registered addresses are not in Australia or New Zealand ('non-residents').[1240] The criterion will be taken to be satisfied in relation to non-residents if the RE follows an alternative procedure. Under that procedure, the RE can:

- decide that it is unreasonable to offer the interests for issue to non-residents, after taking into account:
  - the number of non-residents in the relevant place to whom offers would otherwise be made
  - the number and value of the interests that would otherwise be offered for issue
  - the cost of regulatory compliance in the relevant place
- send details of the offer to each non-resident in that place and advise each non-resident in that place that the non-resident will not be offered the securities or interests
- if the offer can be assigned:
  - appoint a nominee in Australia to sell the invitation or right that would otherwise have been offered to the non-resident and send the non-resident any net proceeds of sale

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1237 Definition of 'regulated person' in s 1011B. Authorised representatives are covered by Part 7.6 Div 5.
1238 s 1012DAA. There is an equivalent exception relating to rights issues in the securities disclosure provisions (s 708AA).
1239 s 9A(2)(a), (c).
1240 s 9A(2)(b).

– advise each non-resident of the nominee's appointment and obligations.[1241]

Analysis and discussion

The 'rights issue' exception from the obligation to give a PDS is generally intended to be available only where all interest holders have an equal opportunity to participate in the rights issue. However, the alternative procedure in the exception recognises that the laws in some jurisdictions outside Australia and New Zealand (overseas jurisdictions) may make it unreasonable to require compliance with the equal opportunity condition in relation to non–resident investors, given the number of non-residents, and the number and value of interests, involved.

This allowance for the circumstances of non–resident investors may not operate properly where there are non-resident investors in more than one overseas jurisdiction.

For instance, a scheme may have non-resident investors in two overseas jurisdictions, for only one of which the specified conditions[1242] are satisfied. It seems that the rights issue exception is available if the RE follows the alternative procedure for investors in both of those jurisdictions (even if would not be unreasonable to require that interest holders in one of those jurisdictions be given the same opportunity to participate in the rights issue as Australian and New Zealand residents), given that:

- the alternative procedure is available whenever the stipulated conditions are satisfied
- those conditions are expressed as relating to one particular place.

This problem is exacerbated if there are non–resident investors in numerous jurisdictions, only one of which satisfies the statutory prerequisites for the exception.

There is no apparent policy reason why non–resident investors in a particular overseas jurisdiction should not have the same opportunity as Australian and New Zealand residents to participate in a rights issue if the statutory prerequisites for the exception are not satisfied in relation to that jurisdiction.

The alternative procedure is also not satisfactory for unregistered schemes, as it requires the taking of certain steps by the RE and unregistered schemes do not have an RE. This difficulty would be avoided if all schemes were required to be registered, as discussed in Section 4.1 of this paper. Even if there is an exception from the registration requirement for small private schemes (as discussed under the heading ***Numerical test*** in Section 4.1), those small schemes may be unlikely to make rights issues and may therefore not need to use the rights issue exception from the disclosure requirements.

However, if significant categories of unregistered schemes remain, an amendment to the definition of 'rights issue' may be necessary, for instance by adding a reference, in the case of unregistered schemes, to 'the holder of the office (by whatever name it is known), in relation to the managed investment scheme, that corresponds most closely to the office of responsible entity of a registered scheme'.[1243]

1241 s 9A(2)(b)(ii), (3).
1242 s 9A(3).
1243 cf s 1012D(8)(b).

Question 16.5.1. Should the definition of 'rights issue' be amended to protect the right of residents of a particular jurisdiction to participate in a rights issue unless it would be unreasonable to require that those residents have that right?

Question 16.5.2. Should the definition of 'rights issue' be amended to apply to rights issues in relation to unregistered schemes and, if so, how?

16.6 Application of the disclosing entity provisions to managed investment schemes

The issue

Is the 100 person test an appropriate criterion for determining whether a scheme should be a disclosing entity?

Current position

The Corporations Act contains the following definition of 'disclosing entity' in relation to a managed investment scheme:

> If any interests in a managed investment scheme are ED securities, the undertaking to which the interests relate is a disclosing entity for the purposes of this Act.[1244]

Securities are only ED securities if they are categorized as such by a specific provision.[1245] The following interests in registered managed investment schemes are ED securities:

- those in a scheme that is listed on a financial market[1246]
- those in a scheme where the managed investments are held by 100 or more people who hold them as a result of offers that required a Product Disclosure Statement (the 100 person test).[1247]

Analysis and discussion

The fact that a scheme has 100 persons as members is not necessarily a satisfactory test for determining whether the scheme should be a disclosing entity, given that the combined economic value of all the interests held by any particular number of persons may or may not be significant.

A monetary test would be a more reliable indicator of the economic significance of a scheme and whether it should be treated as a disclosing entity.

Question 16.6.1. Should the 100 person test be replaced with a test that contains a monetary criterion (for instance, that the scheme has members who acquired their interests as retail clients and involves more than $10 million in assets or satisfies a similar monetary criterion)?

1244 s 111AC(2).
1245 s 111AD.
1246 s 111AE(1A), definitions of 'managed investment product' in ss 9 and 761A, s 764A(1)(b).
1247 s 111AFA.

16.7 Failure to fulfil minimum subscription conditions

The issue

There are two separate requirements for the return of subscription money on failure to fulfil minimum subscription conditions. This may be unnecessary and confusing.

Current position

A Product Disclosure Statement (PDS) may state that a financial product to which the Statement relates will not be issued or sold unless:

- applications for a minimum number of financial products of that kind are received, or
- a minimum amount is raised.

If the PDS makes such a statement, the stipulated condition must be fulfilled before the issue or a sale may take place (s 1016C).

If the condition is not fulfilled within four months after the date of the relevant PDS, s 1016E requires that the person who received the money either:

- repay the applicant, or
- give the applicant additional disclosures and one month to withdraw the application and be repaid.[1248]

The provision does not indicate when repayment must occur.

There is also a more general provision that could apply in this situation. Section 1017E regulates how money received for a financial product should be dealt with before the product is issued. One aspect of that provision is a requirement for an issuer or seller of financial products to return money paid to acquire the product if the issuer or seller does not, for whatever reason, issue or transfer the products immediately after receiving the money. In contrast with s 1016E, s 1017E provides a time within which money must be returned, being either 'before the end of one month starting on the day on which the money was received' or 'if it is not reasonably practicable to do so before the end of that month—by the end of such longer period as is reasonable in the circumstances'.[1249]

Analysis and discussion

It would be in the interests of regulatory simplicity for the return of subscription money on failure to satisfy a condition to be dealt with solely under the provision designed for that purpose (s 1016E). However, it may contribute to greater certainty for that provision to stipulate a definite time within which subscription money must be returned.

Question 16.7.1. Should the return of application money on non-fulfilment of a condition be covered solely by s 1016E, which provides alternative approaches to the reimbursement of investors?

[1248] s 1016E(1)(a)(ii), (2).

[1249] s 1017E(4)(d), (e). For a discussion of s 1017E and the background to that provision, see *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd* [2008] NSWSC 766 at [106]-[133].

Question 16.7.2. If so, should s 1016E be amended to provide a time within which the money must be repaid?

16.8 Right of investors to avoid subscription contracts

The issue

The right of investors to void a contract to subscribe for interests in a scheme by written notice to the offeror can pose an ongoing risk to the operation of the scheme.

Current position

An investor who has obtained an interest in a managed investment scheme in response to an offer for subscription or an invitation to subscribe can void the contract of subscription by written notice to the offeror if:

- the scheme should have been, but was not, registered, or
- the person offering the interest did not comply with the Product Disclosure Statement requirements in Part 7.9 Div 2.[1250]

The initial effect of the notice is to suspend the contract.[1251] Unless the offeror makes a successful application to the court to declare that the notice had no effect,[1252] 'the notice takes effect to void the contract' after a stipulated period.[1253] The court in one case took the quoted words to mean:

> that the contract is void ab initio, with the consequence that the investor can recover what he paid for his investment. In other words, the parties to the contract are to be restored as far as may be possible to the position they were in before the contract was made.[1254]

The legislation does not stipulate a time period within which an investor must take any action to exercise this right.[1255]

Investors do not have an equivalent independent right in relation to interests acquired on a secondary market.[1256]

Analysis and discussion

The right of investors to void a contract of subscription raises several potential problems.

The right poses an ongoing risk to the operation of the scheme. An affected scheme remains at risk of having to return subscription money to investors for an indeterminate period, given that there is no legislative time limit for the exercise of the right. One

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1250 s 601MB. A notice must identify the failure to comply with Part 7.9 Div 2 at the very least in general terms: *Almond Investors Ltd v Emanouel* [2012] VSC 413 at [101].
1251 s 601MB(2).
1252 s 601MB(4)-(6).
1253 The period is 21 days unless the offeror challenges the notice in court, in which case the period is extended to allow for the challenge to be determined: s 601MB(3).
1254 *In The Matter of York Street Mezzanine Pty Ltd (in liq)* [2007] FCA 922 at [47].
1255 It is not clear whether the ability to void the contract is lost once the scheme interest has been issued.
1256 P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶13-200.

possibility is for the legislation to stipulate a time limit. By way of comparison, a client must exercise his or her right to rescind an agreement for the provision of financial services that is entered into with a person who does not hold an Australian financial services licence 'within a reasonable period after becoming aware of the facts entitling the client to give the notice'.[1257]

In addition, the right survives a change in the RE of a scheme. This may hamper attempts to restructure the affairs of the scheme. Any new RE, and its directors, should be able to operate the scheme without the risk of investors in the scheme voiding their contracts of subscription.

Also, where the right relates to a defective Product Disclosure Statement:

- it remains regardless of any attempt to rectify the defect in the PDS that gave rise to the right, and
- it may relate to only a minor defect in the PDS.

On one view, the right of investors to avoid subscription contracts where the PDS was defective is unnecessary, given that investors have specific remedies where they have acquired a financial product relying on a defective PDS.[1258]

A possible alternative to the right to void a contract for subscription may be a right to claim compensation for loss from parties that were involved when the original breach was committed, for instance:

- the promoter of the scheme
- the RE that was in office at the relevant time
- the directors of that RE at the relevant time.

However, this approach may leave an investor without an effective remedy if those parties do not have assets to meet any claim.

The SLE Proposal may exacerbate, rather than resolve, the problems arising from the right of investors to void their contracts of subscription, as the MIS that was the legal entity that was involved at the time of the contravention would remain, regardless of any change in the RE.[1259]

Question 16.8.1. Should the right for investors to void a contract to subscribe for interests in a scheme be amended and, if so, how? For instance, should the right:

- be excluded for non-compliance with a PDS
- be replaced with a right for the investor to seek damages from specified parties who were involved in the original contravention
- incorporate a clear time limit for its exercise and, if so, what should that time limit be?

1257 s 925A(2).
1258 s 1016F.
1259 The SLE Proposal is summarised in Section 1.1.1 of this paper.

16.9 Certificates of interests

The issue

The requirement for the RE of a registered scheme to issue certificates of interest may be obsolete.

Current position

The RE of a registered scheme must issue certificates of interests to persons who acquire interests in the scheme (whether by way of issue or transfer).[1260]

Analysis and discussion

It has become less common for physical certificates of interests to be issued. Scheme constitutions often contain a provision to the effect that certificates will not be issued. This raises the question whether the legislation should continue to require certificates of interests.

The key concern should be to be able to identify who has an interest in the scheme. This goal may be more appropriately achieved through a definitive register of scheme members (see Section 3.2 of this paper).

Question 16.9.1. Should the RE of a registered scheme be required to issue certificates of interests in the scheme to persons who acquire interests in the scheme?

16.10 Obligations to assist those having supervisory responsibilities

The issue

There are inconsistencies in the parties who are required to give assistance to ASIC, the auditor of the compliance plan and the compliance committee in relation to compliance.

Current position

Various parties have a statutory responsibility for checking on compliance with the managed investments supervisory framework, with various other parties having a responsibility for assisting those who have the responsibility for checking.

[1260] ss 1071A, 1071H.

The table below sets out the respective parties and indicates where there are gaps.

Party to be assisted and nature of that party's responsibility	Party responsible for assisting					
	RE	**Officers of the RE**	**Agent of the RE**	**Officers of agent of the RE**	**Person other than agent engaged by the RE**	**Member of compliance committee**
ASIC: check compliance with: • constitution • compliance plan • Corporations Act (s 601FF(1))	√ (s 601FF(2))	√ (s 601FF(2))	√ (Corp Reg 5C.2.01, but only in relation to the constitution and the compliance plan)	X	X	√ (s 601JD(2))
Auditor of RE's compliance with the scheme's compliance plan (s 601HG(3))	X	√ (s 601HG(6))	√ (Corp Reg 5C.4.02)	√ (Corp Reg 5C.4.02)	X	X
Compliance committee: • monitor compliance with compliance plan and report to RE • report to RE on breach of Act or scheme constitution • report to ASIC in the absence of RE action • regularly assess adequacy of compliance plan and recommend remedial action (s 601JC)	√ (Corp Reg 5C.5.01)	√ (Corp Reg 5C.5.01)	√ (Corp Reg 5C.5.01)	√ (Corp Reg 5C.5.01)	X	X
Auditor of scheme's financial statements	X	√ (s 312)	X[1261]	X	X	X

Also, the stipulated provisions do not require persons who formerly occupied any of these positions to assist.

A comparison might be drawn with the voluntary administration provisions, under which each director has a duty to assist the administrator in relation to books of the company[1262] and to attend on the administrator and give the administrator such information about the company's business, property, affairs and financial circumstances as the administrator reasonably requires.[1263] In addition, the directors collectively have an obligation to give to the administrator a statement about the company's business, property, affairs and financial circumstances.[1264]

[1261] While there are no relevant statutory requirements, ASIC requires that an agreement between an RE and any asset holder (such as a custodian) require the asset holder to provide all reasonable assistance to any auditor engaged to audit the financial statements of the scheme (Regulatory Guide 133 *Managed investments and custodial or depository services: Holding assets* at RG 133.91).

[1262] s 438B(1).

[1263] s 438B(3).

[1264] s 438B(2).

Analysis and discussion

There have been various recommendations to remedy some of the inconsistencies in the current law.[1265]

There is no reason why any person involved in a scheme should not have an obligation to assist those who have been given supervisory responsibility in relation to compliance for a scheme.

Each of the persons identified in the above table should have an obligation to assist each of the parties identified as having supervisory responsibilities.

Question 16.10.1. What amendments, if any, should be made to the provisions imposing obligations to give assistance to ASIC, the auditor of the compliance plan and the compliance committee in relation to compliance?

16.11 Reporting breaches to ASIC

The issue

The periods within which the RE must comply with the various requirements for reporting breaches of the law to ASIC are not consistent.

Current position

The RE of a registered scheme has an obligation under the managed investment provisions to report to ASIC any breach of the Corporations Act that relates to the scheme and has had, or is likely to have, a materially adverse effect on the interests of members.[1266] This is to be done 'as soon as practicable after [the RE] becomes aware of the breach'.[1267]

The RE, as the holder of an Australian financial services licence, also has a separate obligation under the financial services licensing provisions to report breaches or likely breaches of specific financial services licensing obligations 'as soon as practicable and in any case within 10 business days after becoming aware of the breach or likely breach'.[1268]

By way of comparison, the time periods for reporting offences and misconduct in the context of external administration are that:

- a receiver or managing controller must report 'as soon as practicable'[1269]
- a liquidator must report 'as soon as practicable, and in any event within 6 months'.[1270]

Also, the reporting obligations of external administrators apply not just to the Corporations Act, but to any law of the Commonwealth, a State or a Territory.[1271]

1265 The Turnbull Report (Section 5.2.8) recommended that the requirement to assist the auditor of the compliance plan and the compliance committee should be extended to include persons other than agents of the RE. The ASIC submission at Stage 1 of the CAMAC review proposed that the obligation to assist ASIC in conducting a check be extended to agents and other persons engaged to perform an RE's functions.

1266 s 601FC(1)(l).

1267 ibid.

1268 s 912D(1), (1B).

1269 s 422.

1270 s 533(1)(d).

Analysis and discussion

It would be desirable to have a uniform test for the period within which reports of breaches of the law (including licence conditions) should be made to ASIC, and the extent of the reporting obligation, unless there is good reason for a different time to be specified in a particular instance.

Question 16.11.1. What is the appropriate period within which the RE should report breaches of the law (including breaches of licence conditions) to ASIC?

Question 16.11.2. Should the RE's reporting obligation extend to any law of the Commonwealth, a State or a Territory?

[1271] For receivers, see s 422, definition in s 9 of 'offence' ('offence means an offence against a law of the Commonwealth or a State or Territory'); for administrators, see s 438D, definition in s 9 of 'offence'; for liquidators, see s 533.

Appendix 1 Criteria for determining whether a scheme should be registered

Overview

A managed investment scheme must be registered if:

- it (by itself or together with other closely related schemes as determined by ASIC) involves more than 20 investors (the numerical test),[1272] and/or
- it was promoted by a person, or an associate of a person, who was in the business of promoting managed investment schemes at the time the scheme was promoted (the professional promoter test).[1273]

A scheme that satisfies either or both of these tests is nevertheless exempt from the requirement to be registered if none of the issues of interests in the scheme would have activated the Product Disclosure Statement (PDS) requirements in Division 2 of Part 7.9 of the Corporations Act[1274] (the disclosure test).

The professional promoter test and the disclosure test are discussed in more detail below.

The professional promoter test

A scheme that does not satisfy the numerical test for registration may nevertheless have to be registered if it satisfies the professional promoter test.

The application of the professional promoter test requires two steps:

- the determination of who is promoting the scheme
- the determination of whether that person, or an associate of that person, was in the business of promoting managed investment schemes at the time the scheme was promoted.

The legislation provides no guidance on either of these matters. However, there has been some judicial guidance.

When does a person 'promote' a scheme

Judicial comments relating to the meaning of promotion of a scheme include:

1272 s 601ED(1)(a), (c), (3).
1273 s 601ED(1)(b).
1274 s 601ED(2), Corp Reg 5C.11.05A.

- the term 'promoter' has no very definite meaning[1275] and sums up 'a number of business operations familiar to the commercial world by which a company [or scheme] is generally brought into existence'[1276]

- 'promoted' 'plainly extends to activities in which a person formulates a scheme ..., advertises it, solicits others to participate in it and embarks upon its implementation'[1277]

- 'promoter' means a person who 'engaged in exertion for the purpose of getting up and starting' a scheme and a person who assists.[1278]

What constitutes the 'business of promoting managed investment schemes'

Judicial comments on the meaning of 'business of promoting managed investment schemes' include:

- the business must involve the promotion of more than one scheme, though the 'promotion of a single project' may satisfy the test 'if that undertaking is the first in a business of promoting similar undertakings'[1279]

- there is a business of promoting managed investment schemes where the aim of the business is to seek out investment opportunities, offer them to members, elicit subscriptions and manage the investments on behalf of the participating members, with these activities being done for profit[1280] (it follows that the person who carries out these activities is a promoter)

- there is a 'business of promoting managed investment schemes' where the relevant persons undertake the schemes 'in the course of business activities with a view to profit and ... having in mind the undertaking of other such schemes'[1281]

- a person may be 'in the business of promoting' schemes even if the relevant schemes constitute only a small part of the person's business activities, as a person may carry on or be involved in more than one business at any given time.[1282]

1275 *ASIC v Young* [2003] QSC 29 at [50], which refers to a line of authority that includes *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215 at 241-242, *Emma Silver Mining Co Ltd v Lewis & Son* (1879) 4 CPD 396, *Twycross v Grant* (1877) 2 CPD 469.

1276 *ASIC v Young* [2003] QSC 29 at [51], citing *Whaley Bridge Calico Printing Co v Green* (1880) 5 QBD 109 at 111.

1277 *ASIC v Young* [2003] QSC 29 at [53]. See also *ASIC v Primelife Corporation Ltd* [2005] FCA 1229.

1278 *ASC v Woods and Johnson Developments Pty Ltd* (1991) 9 ACLC 1,492 at 1,495, following *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215. See also *ASIC v Young* [2003] QSC 29 at [50].

1279 *ASC v Woods and Johnson Developments Pty Ltd* (1991) 9 ACLC 1,492 at 1,494, 1,496. The rule of interpretation that the plural includes the singular (*Acts Interpretation Act 1901* s 23(b)) is excluded by the context in which the word 'schemes' is used (at 1,494).

1280 *ASIC v Chase Capital Management Pty Ltd* [2001] WASC 27 at [61].

1281 *ASIC v Young* [2003] QSC 29 at [54]-[55].

1282 *ASIC v Young* [2003] QSC 29 at [55].

The disclosure test

The elements of the test

The disclosure test applies where none of the issues of interests in the scheme would have activated the Product Disclosure Statement (PDS) requirements in Division 2 of Part 7.9 of the Corporations Act.[1283]

When a decision is being made about whether the PDS requirements would have applied to issues of interests, two assumptions must be made:

- that the scheme had been registered when the issues were made[1284]
- that the Product Disclosure Statement provisions applied to interests in the scheme when the need for registration was being assessed.[1285]

There are two aspects of the disclosure test that warrant further analysis:

- the test is activated, and hence the scheme is exempt from registration, where no PDS is required for issues of interests, even if a PDS is required for sales of interests
- there are various situations in which a PDS is not required and which therefore satisfy the disclosure test.

Application to issues of interests only

Obligations to give a PDS arise in certain circumstances relating to giving advice about financial products[1286] or the issue[1287] or sale[1288] of financial products, as well as in relation to certain acquisitions under a custodial arrangement.[1289]

However, the disclosure test refers only to issues of interests in a scheme. In particular, it does not refer to sales of interests,[1290] even though there are PDS requirements for certain sales, or sale offers, that amount to an indirect issue,[1291] namely where:

- the sale is made off-market by a seller who controls[1292] the issuer (an *off-market sale by a controller*),[1293] or

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1283 s 601ED(2), Corp Reg 5C.11.05A.
1284 This is part of s 601ED(2) itself.
1285 This is pursuant to Corp Reg 5C.11.05A, which modifies s 601ED(2).
1286 s 1012A.
1287 s 1012B.
1288 s 1012C.
1289 s 1012IA. There is also a PDS requirement in relation to the provision of superannuation products. An issuer who is to provide superannuation products to the employees of an employer-sponsor of a superannuation entity must give the employer-sponsor a Product Disclosure Statement for each of the superannuation products (s 1012I).
1290 Sales of interests may be covered by the disclosure test if the broader meaning of 'issue' in the definition in s 9 is taken to apply to Part 7.9 and is taken to cover sales made under an arrangement with the promoter. However, such an interpretation of 'issue' is speculative at best.
1291 s 1012C. This PDS requirement applies to offers to sell a financial product to a retail client (s 1012C(3)) and offers by a retail client to acquire a financial product (s 1012C(4)). Paragraph (b) of the definition of 'regulated person' in s 1011B covers a seller of a financial product in certain circumstances.
1292 As defined in s 50AA.

- the sale amounts to an indirect issue of the financial product (a *sale amounting to an indirect issue*),[1294] or

- the sale amounts to an indirect off-market sale by a person who controls[1295] the issuer (a *sale amounting to an indirect off-market sale by a controller*).[1296]

These PDS sale requirements were included to prevent avoidance of the requirement for a PDS for the issue of scheme interests.[1297] Given that the disclosure test fails to mention sales, a scheme is exempt from the requirement to be registered if no issues of interests in the scheme would require a PDS, even if sales of interests in the scheme would require a PDS. This would be the case where wholesale investors in a scheme on-sell their interests to retail investors in circumstances amounting to an indirect issue (that is, through an off-market sale by a controller, a sale amounting to an indirect issue or a sale amounting to an indirect off-market sale by a controller).

Circumstances in which a PDS is not required

A PDS is not required where all the issues of interests in the scheme are to wholesale clients[1298] (unless a wholesale client acquires an interest pursuant to an instruction given by a retail client under a custodial arrangement[1299]). The disclosure test therefore has the effect that wholesale-only schemes are exempt from the requirement to be registered.[1300]

There are, however, other reasons why a PDS may not be required for issues of interests in a scheme (with the secondary consequence, under the disclosure test, that a scheme does not have to be registered).

1293 s 1012C(5). The sale may be made off-market either because the product cannot be traded on a licensed market or because the offer is not made in the ordinary course of trading on a licensed market (s 1012C(5)(b)). According to the Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* (at para 8.106): 'A controller of a body will either have direct access to, or be in a position to obtain, the necessary information to prepare a disclosure document.'

1294 s 1012C(6). This occurs when the seller, to whom the financial product was originally issued, offers to sell the product to the retail client within 12 months after issue and the product was issued without a PDS and with the purpose (on the part of the issuer or the seller) of on-selling the product.
The requisite purpose is taken to exist if there are reasonable grounds for reaching this conclusion (s 1012C(7)(a)). There is a rebuttable presumption that this is the case if the financial product or a financial product of the same kind issued at the same time is subsequently sold, or offered for sale, within 12 months after issue (s 1012C(7)(b)).

1295 As defined in s 50AA.

1296 s 1012C(8). This occurs when the seller, who acquired the financial product off-market from a person who controls the issuer (the controller), offers to sell the product to the retail client within 12 months after the acquisition from the controller and the product was sold without a PDS and with the purpose (on the part of the controller or the seller) of on-selling the product.
The sale may be made off-market either because the product cannot be traded on a licensed market or because the offer is not made in the ordinary course of trading on a licensed market (s 1012C(8)(b)).
The requisite purpose is taken to exist if there are reasonable grounds for reaching this conclusion (s 1012C(9)(a)). There is a rebuttable presumption that this is the case if the financial product or a financial product of the same kind sold by the controller at the same time is subsequently sold, or offered for sale, within 12 months after issue (s 1012C(9)(b)).

1297 Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 14.33-14.35.

1298 The PDS requirements for issues only apply in relation to issues, or issue offers, that involve retail clients: s 1012B. See Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 14.15, 14.69. In addition to issues of a financial product (s 1012B(3)(a)(iii)), the PDS requirement applies to offers to issue a financial product (s 1012B(3)(a)(i)) and offers to arrange for such an issue (s 1012B(3)(a)(ii)), as well as offers by a retail client to acquire a financial product by way of issue (rather than transfer) (s 1012B(4)(a)). Paragraph (a) of the definition of 'regulated person' in s 1011B covers an issuer of a financial product.

1299 s 1012IA.

1300 P Hanrahan, CCH, *Managed Investments Law and Practice* (looseleaf) at ¶1-500 nominates the exemption of wholesale schemes as the purpose of s 601ED(2) (see also at ¶10-340).

The PDS requirements do not apply if the issues constitute a small–scale offering (in essence, an offering that involves personal offers that result in no more than 20 persons purchasing interests and raise no more than $2 million in any 12 month period).[1301] There is also a disclosure exemption for an issue or sale made to a person associated with the RE.[1302] The small–scale offering exemption and the associated person exemption would cover small private schemes.

In addition, the PDS requirements do not apply to an issue where:[1303]

- the client is not in Australia[1304]
- the client has already received an up-to-date PDS.[1305] For instance, clients who have received a PDS on receiving advice about interests in a proposed managed investment scheme need not be given another PDS when those interests are issued to them
- the client is providing no consideration for the issue or sale of the interests[1306]
- the issue or sale is made as part of a takeover bid and the offer of interests in the scheme is accompanied by a bidder's statement.[1307]

1301 s 1012E. The complete criteria for a small–scale offering are:
- the offers are personal offers (s 1012E(2): personal offer is defined in s 1012E(5))
- all the financial products are issued by the same person (s 1012E(2)(a))
- the total number of persons purchasing as a result of the offers does not exceed 20 in any 12 month period (s 1012E(2)(b); the criteria for determining whether there has been a breach of this condition are contained in s 1012E(6)(a), (7)(a), (8), (9))
- the amount raised by the issuer as a result of the offers does not exceed $2 million in any 12 month period (s 1012E(2)(c); the criteria for determining whether there has been a breach of this condition are contained in s 1012E(6)(b), (7)(b), (8), (9), (10)).

The test was formerly based on 20 offers in 12 months. That test was replaced by the *Corporate Law Economic Reform Program Act 1999*, as it was regarded as 'unduly restrictive and difficult to apply in practice' (the Explanatory Memorandum to the Bill for that Act at para 8.46). That change was supported by the *Financial System Inquiry Final Report* (1997) (the Wallis report) at 278.

HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.130] states that 'the justification for the exclusion seems to be the concept that a disclosure document should not be required for a private offer, because the offeree can make inquiries of the offeror on a face-to-face basis and the cost of requiring a disclosure document is likely to be disproportionately high'.

1302 s 1012D(9A). The categories of associated person are a senior manager of the RE or of a related body corporate, a spouse, parent, child, brother or sister of a person in that category or a body corporate controlled by a person in one of the first two categories (s 1012D(9B)). These provisions were included to ensure that this exemption, available for securities disclosure under Chapter 6D (s 708(12)), continued to apply to disclosure for managed investment products under Part 7.9 (Supplementary Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 3.125-3.126).

1303 Other PDS exemptions would not flow through to the PDS-related exemption from registration, namely:
- the client has, or has access to, up-to-date information through a PDS or ongoing information provided under s 1017B or s 1017D, as the client is already an investor in the scheme (s 1012D(2), (10)(b))
- the client already holds interests of the same kind and the circumstances relate to a distribution reinvestment plan or a switching facility (s 1012D(3))
- the client is issued the interests under a rights issue (s 1012DAA) and will therefore already have received a PDS for the original interests.

1304 s 1012D(8A), as inserted by Corp Reg 7.9.07FB, enacted pursuant to s 1012G(1)(c). The regulation refers to the client not being in 'this jurisdiction'. Section 9 defines 'this jurisdiction' as referring to the geographical area consisting of each of the States, the Australian Capital Territory, the Northern Territory and, in some circumstances, an external Territory.

1305 s 1012D(1).

1306 s 1012D(5).

1307 s 1012D(7). HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.130.21] states, in relation to the equivalent securities disclosure exemption, that:

History of the disclosure test

An exception along the lines of what is now the disclosure test has been in the managed investment provisions since they were first introduced in 1998. At all times, the key element of the test has been whether all the issues of interests in the scheme, when they were made, would have been exempt from the relevant disclosure obligations. However, the range of issues exempted from those disclosure obligations has grown over time.

In 1998, scheme interests were regulated as securities and the relevant categories of issues that did not require disclosure in a prospectus (excluded issues)[1308] were:

- issues to wholesale or professional investors (issues with a minimum subscription amount for each person of at least $500,000[1309] or issues to an underwriter under an underwriting agreement[1310])
- small-scale offerings (issues to no more than 20 persons in the preceding 12 months)[1311] in relation to a registered scheme
- issues to associated persons.[1312]

These exemptions were clearly focused on exempting from disclosure schemes that did not involve large numbers of retail investors. They provided a coherent basis for determining the content of the scheme registration exemption (though, as discussed in Section 4.1 of this paper, CAMAC questions whether there should be a registration exemption for wholesale-only schemes).

These original three disclosure exemption categories remained under the amendments made by the *Corporate Law Economic Reform Program Act 1999*,[1313] in an expanded form in the case of the small-scale offerings exemption and the wholesale/professional investors exemption.[1314] The CLERP amendments also introduced two additional exemptions from the prospectus disclosure requirements in relation to:

The policy underlying this exemption is that the disclosure requirements for a bidder's statement are regulated by Ch 6, which grants special powers to ASIC and the Panel, and therefore there should not be an additional disclosure regime supervised by ASIC and the court under Ch 6D. Nevertheless, the disclosure requirements for a bidder's statement import the basic requirements of Ch 6D in the case of a scrip bid: s 636(1)(g).

1308 Under the law as it stood when the managed investment provisions were introduced in 1998, the test in s 601ED(2) was whether the issues of interests in the scheme were 'excluded issues' of securities. 'Excluded issues' were not subject to the prospectus provisions (Corporations Law s 1017(a)).

1309 Corporations Law s 66(2)(a).

1310 Corporations Law s 66(2)(b).

1311 Corporations Law s 66(2)(d).

1312 Corporations Law s 66(2)(e). Certain issues of interests in a managed investment scheme made pursuant to a prospectus were also covered by the definition of 'excluded issue' (Corporations Law s 66(2)(m)).

1313 Corporations Law s 708(1)-(7) (small-scale offerings exemption), s 708(8)-(11) (wholesale/professional investors exemption), s 708(12) (associated persons exemption).

1314 The small-scale offerings category gained a new criterion relating to the amount raised (no more than $2 million in the preceding 12 months), to operate in conjunction with the criterion relating to the number of investors (issues to no more than 20 persons in the preceding 12 months) (Corporations Law s 708(1)-(7)).
A greater range of wholesale/professional investors was specified as not requiring disclosure, namely:
- investors who have paid at least $500,000 for the issue and any previous issues (Corporations Law s 708(8)(a), (b), (9))
- investors with net assets of at least $2.5 million or a gross annual income for each of the previous 2 financial years of at least $250,000, as certified by a qualified accountant (Corporations Law s 708(8)(c))
- investors to whom an offer is made through a licensed dealer, who is satisfied that they have relevant experience in investing in securities (Corporations Law s 708(10))
- brokers and advisers who are either licensed or exempt from licensing and are acting as principal (Corporations Law s 708(11)(a)-(b))

- issues and sales requiring no consideration,[1315] and
- offers made as part of a takeover bid and accompanied by a bidder's statement.[1316]

These changes to the disclosure obligations had the effect of changing the scope of the disclosure test in the scheme registration requirement, though there is no evidence that the consequences for the scheme registration criteria were taken into account when the disclosure requirements were being amended.[1317]

With the enactment of the *Financial Services Reform Act 2001*, the prospectus requirements for the issue of interests in managed investment schemes were replaced with Product Disclosure Statement requirements (as discussed in Section 10.4.3 of this paper). The exemptions from the PDS requirements (as described above under ***Circumstances in which a PDS is not required***) were substantially the same as the exemptions from the disclosure requirements under the CLERP amendments, with the following exceptions:

- the wholesale exemption was achieved by making the PDS requirements applicable only where retail clients were involved[1318]
- no PDS was required if the client had already received a PDS[1319] (for instance, where the issue of interests in a scheme followed the giving of advice on those interests)
- no PDS was required if the client already held interests of the same kind and the circumstances related to a distribution reinvestment plan or a switching facility.[1320]

As with the changes to the disclosure exemptions made by the CLERP amendments, there is no evidence that the consequences for the scheme registration criteria were taken into account when the disclosure requirements were being amended.

- various registered or regulated bodies (Corporations Law s 708(11)(c)-(g))
- persons who control at least $10 million for the purpose of investment in securities (Corporations Law s 708(11)(h)).

The exemption for issues to associated persons appeared in s 708(12) under the CLERP amendments.

1315 Corporations Law s 708(15). This exemption has been maintained for prospectuses in the Corporations Act s 708(15). It also applies to the Product Disclosure Statement requirements for managed investments: s 1012D(5). See Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 14.47.

1316 Corporations Law s 708(18). This exemption has been maintained for prospectuses in the Corporations Act s 708(18). It also applies to the Product Disclosure Statement requirements for managed investments: s 1012D(7). See Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 14.49.

1317 The Explanatory Memorandum to the Bill for the *Corporate Law Economic Reform Program Act 1999* did not comment on the effect that the change in the disclosure exemptions might have on the exemption from registration.

1318 ss 1012B, 1012C.

1319 s 1012D(1). See Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* paras 14.39-14.40.

1320 s 1012D(3).

Appendix 2 Definitions of 'securities' and their application to interests in schemes

The principal provision that defines 'securities' contains five definitions:[1321]

- a definition that is used unless one of the other definitions applies[1322] (the general definition)
- a definition that applies when the term 'securities' is used in relation to a body (this definition includes 'interests in a managed investment scheme made available by the body')[1323] (the definition in relation to a body)
- a definition (the control and continuous disclosure definition) to be used in relation to:
  - takeovers (Chapters 6 and 6B of the Corporations Act)
  - compulsory acquisitions and buyouts (Chapters 6A and 6B)
  - ownership of companies and schemes (Chapter 6C), and
  - continuous disclosure (Chapter 6CA) and disclosing entities (Part 1.2A)[1324]
- a definition to be used in relation to financial services and markets[1325] (the financial markets definition)
- a definition to be used in relation to fundraising[1326] (the fundraising definition, which for the most part is the same as the financial markets definition[1327]).

These definitions vary in the extent to which they cover:

- interests in schemes ('primary interests'), and
- 'secondary interests' in those schemes, being:
  - legal or equitable rights or interests in the primary interests
  - options to acquire the primary interests
  - options to acquire legal or equitable rights or interests in the primary interests.

1321 Section 9 of the Corporations Act states that 'securities' has the meaning given by Section 92. There is a further definition of 'securities' in s 1200A(1) for the purpose of Chapter 8, which covers mutual recognition of securities offers. Chapter 8 of the Corporations Act is discussed in Section 14.1 of this paper.

1322 s 92(1).

1323 s 92(2).

1324 s 92(3).

1325 ss 92(4), 761A. The Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* stated (at para 6.75): 'Although the defined term 'security' is in the singular, it is intended that references to the plural 'securities' in Chapter 7 are also to be taken to refer to this definition, rather than the definition of 'securities' in section 92.'

1326 ss 92(4), 700.

1327 The elements of the financial markets definition that are excluded from the fundraising definition are:
- certain acquisition rights under a rights issue
- a depository interest that can be transferred through a licensed clearing and settlement facility (a CGS depositary interest): s 700(1), paragraphs (e) and (f) of the definition of 'security' in s 761A.

Of the five definitions, only the control and continuous disclosure definition applies to all primary and secondary interests in schemes.[1328]

The financial markets definition applies to neither primary nor secondary interests in schemes. However, both types of scheme interests come within the legislative frameworks for financial markets and services, as they fall within the definition of 'financial product'.[1329]

The fundraising definition also does not apply to primary or secondary interests in schemes. Financial product disclosure for these interests is governed by Part 7.9 of the Corporations Act (financial product disclosure) (introduced by the *Financial Services Reform Act 2001*), rather than by Chapter 6D (fundraising).[1330] The change in disclosure requirements for schemes from the prospectus requirements in Chapter 6D to the Product Disclosure Statement requirements in Part 7.9 is discussed in Section 10.4.1 of this paper.

Neither the general definition nor the definition in relation to a body covers secondary interests in schemes.[1331]

The table below summarises whether the various types of interest in a managed investment scheme come within each of the definitions of 'securities'.

1328 It was considered 'appropriate that the takeovers provisions continue to apply to managed investments': Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001* para 6.73.

1329 s 764A(1)(b).

1330 See paras 14.8-14.10, 20.43 of the Revised Explanatory Memorandum to the Bill for the *Financial Services Reform Act 2001*.

1331 The general definition and the definition in relation to a body cover secondary interests through the concept of 'unit', rather than by including them directly, as in the other definitions. 'Unit' is defined in s 9 as follows:

> **unit**, in relation to a share, debenture or other interest, means a right or interest, whether legal or equitable, in the share, debenture or other interest, by whatever term called, and includes an option to acquire such a right or interest in the share, debenture or other interest.

However, notwithstanding the reference in this definition to 'a share, debenture or other interest', the relevant parts of the general definition (s 92(1)(d)) and the definition in relation to a body (s 92(2)(d)) refer only to 'units' of 'shares', not 'units' of 'interests in managed investment schemes' (or 'units' of 'debentures').

Definition	Type of interest			
	Interest in a managed investment scheme ('a managed investment interest'))	**Legal or equitable rights or interests in a managed investment interest**	**Option to acquire a managed investment interest**	**Option to acquire legal or equitable rights or interests in a managed investment interest**
General definition	Yes [s 92(1)(c)]	No (as only 'units' of 'shares' are 'securities' under s 92(2)(d), not 'units' of any other types of securities)	***General:*** No (as only 'units' of 'shares' are 'securities' under s 92(2)(d), not 'units' of any other types of securities)	No (as only 'units' of 'shares' are 'securities' under s 92(2)(d), not 'units' of any other types of securities)
Definition in relation to a body	Yes [s 92(2)(c)]	No (as only 'units' of 'shares' are 'securities' under s 92(2)(d), not 'units' of any other types of securities)	No (as only 'units' of 'shares' are 'securities' under s 92(2)(d), not 'units' of any other types of securities)	No (as only 'units' of 'shares' are 'securities' under s 92(2)(d), not 'units' of any other types of securities)
Control and continuous disclosure definition	Yes [s 92(3)(c): *registered schemes only*]	Yes [s 92(3)(d)(iii): *registered schemes only*]	Yes [s 92(3)(e) in combination with s 92(3)(c): *registered schemes only*]	Yes [s 92(3)(e) in combination with s 92(3)(d)(iii): *registered schemes only*]
Financial markets definition	No [an interest in a registered scheme is a separate category of 'financial product' in Chapter 7 (s 764A(1)(b)(i)), distinct from a 'security' (s 764A(1)(a)]	No [a legal or equitable right or interest in an interest in a registered scheme is a separate category of 'financial product' in Chapter 7 (s 764A(1)(b)(ii) in combination with s 764A(1)(b)(i)), distinct from a 'security' (s 764A(1)(a)]	No [an option to acquire, by way of issue, an interest in a registered scheme is a separate category of 'financial product' in Chapter 7 (s 764A(1)(b)(iii) in combination with s 764A(1)(b)(i)), distinct from a 'security' (s 764A(1)(a)]	No [an option to acquire, by way of issue, a legal or equitable right or interest in an interest in a registered scheme is a separate category of 'financial product' in Chapter 7 (s 764A(1)(b)(iii) in combination with s 764A(1)(b)(i), (ii)), distinct from a 'security' (s 764A(1)(a)]
Fundraising definition [managed investment products, and interests in and options over them, are governed by the product disclosure requirements of Pt 7.9[1332]]	No [see above note in relation to the financial markets definition]	No [see above note in relation to the financial markets definition]	No [see above note in relation to the financial markets definition]	No [see above note in relation to the financial markets definition]

[1332] HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [22.090].