



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 84

Managed investment schemes: withdrawal rights and scheme liquidity

July 2007

What this paper is about

- 1 This consultation paper sets out our proposed guidance on:
 - (a) what disclosures responsible entities of pooled mortgage schemes should make to members about their withdrawal rights; and
 - (b) how responsible entities of pooled mortgage schemes should monitor and manage liquidity risks.

Following the consultation process, we propose to issue final guidance on these matters.

- 2 This paper also discusses certain legal issues raised by the withdrawal provisions in Pt 5C.6 of the *Corporations Act 2001* (Act) and seeks submissions on whether we should give relief so that a scheme constitution may provide for more than one withdrawal period to apply at any one time.

- 3 The Appendix to this paper contains details of the regulatory regime applying to withdrawal rights and an overview of pooled mortgage schemes.

Why are we releasing this paper?

- 4 The release of this paper has been prompted by certain features of pooled mortgage schemes that may raise liquidity risks. ASIC is concerned that there is a risk of a mismatch arising between investors' expectations and the ability of the responsible entities of some pooled mortgage schemes to permit withdrawals.

- 5 Pooled mortgage schemes face significant challenges in managing their liquidity. For example, many pooled mortgage schemes are marketed on the basis that withdrawal requests are generally satisfied within a few days, even though:

- (a) scheme constitutions may allow up to several months to satisfy withdrawal requests;
- (b) it will often take considerably longer to realise mortgage loans held by pooled mortgage schemes than the time within which investors expect to be able to withdraw; and
- (c) the strength of the market for mortgage loans is likely to vary according to surrounding economic circumstances such as the strength of the property market and the level of mortgage defaults.

Note: Many debenture issuers that carry on secured lending businesses face similar issues to pooled mortgage schemes and some of our comments on pooled mortgage schemes may also be relevant to debenture issuers and trustees. However, this paper is directed to pooled mortgage schemes and other registered schemes rather than debenture issuers.

Who is affected?

6 Our proposals are particularly relevant to pooled mortgage schemes. They are also relevant to other types of registered schemes, especially those that have similar features to pooled mortgage schemes. Where there are potential liquidity risks (as is the case for some pooled mortgage schemes), it is especially important for responsible entities to ensure that they meet their obligations to:

- (a) make adequate disclosure of withdrawal rights and liquidity risks, including having a reasonable basis for forward looking statements about these matters; and
- (b) adequately monitor and manage liquidity risks.

7 ASIC is monitoring, and will continue to monitor, pooled mortgage schemes to check that responsible entities are complying with these obligations. If there is evidence of non-compliance, ASIC will consider issuing stop orders in relation to any defective Product Disclosure Statement (PDS) for a pooled mortgage scheme or taking other enforcement action as appropriate.

The consultation process

8 We invite your comments on our proposals and questions in this paper. We would also like to receive any qualitative or quantitative information to support your comments. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Business Cost Calculator Report and/or a Regulation Impact Statement: see Section 4.

9 All submissions will be treated as public documents unless you specifically request that we treat the whole or part of your submission as confidential.

Your comments

Comments are due by 21 August 2007 and should be sent to:

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You can also contact ASIC Infoline on 1300 300 630 for information and assistance.

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Section 1: Disclosure and withdrawal rights

1.1 This section sets out our proposed guidance on what responsible entities must do to satisfy their disclosure obligations in relation to withdrawal rights and scheme liquidity.

1.2 In particular, we discuss the type of steps responsible entities may need to take to establish reasonable grounds for forward looking statements about withdrawal rights and scheme liquidity.

General requirements

1.3 If investors are given the right to withdraw from a scheme, we expect that this will usually mean that the PDS must contain information about:

- (a) the current and future prospects of liquidity of the scheme (as defined in Pt 5C.6);
- (b) the ability of investors to withdraw from the scheme when the scheme is liquid (if there is a realistic possibility of the scheme being liquid);
- (c) the ability of investors to withdraw from the scheme when the scheme is not liquid (if there is a realistic possibility of the scheme not being liquid);
- (d) the withdrawal period that will apply to withdrawal requests when the scheme is liquid; and
- (e) any significant risk factors that may impact on the ability of investors to withdraw from the scheme (including risk factors that may impact on the liquidity of the scheme).

Some specific disclosure issues raised by withdrawal rights are discussed below.

Your feedback

Q1.1 Are there any other matters concerning the rights of investors to withdraw that should generally be disclosed in a PDS?

Liquidity under Pt 5C.6 and in general

1.4 There is a distinction between a scheme being liquid for the purposes of Pt 5C.6 (which relates to satisfying a statutory test) and the more general meaning of an investment being liquid (which implies that the investment is readily convertible into cash). It is important that any disclosure to investors does not confuse these two concepts.

1.5 For example, if a constitution provides for a long withdrawal period, the scheme could be liquid for the purposes of Pt 5C.6 even though members are not able to withdraw from the scheme until after a substantial period of time. To avoid misleading investors, the PDS for a liquid scheme with a long withdrawal period would generally need to ensure that any disclosure that the scheme is liquid for the purposes of Pt 5C.6 does not imply that investors will be able to withdraw from the scheme within a relatively short period.

Disclosures about withdrawal periods

Withdrawal period under constitution and as applied in practice

1.6 Even though the constitutions of certain schemes may provide for a long withdrawal period (meaning that the schemes are more likely to be liquid for the purposes of Pt 5C.6), the schemes may operate so that withdrawal requests are generally satisfied within a much shorter period. The PDSs for these schemes may represent that, despite the long withdrawal period in the constitution, withdrawal requests have historically been satisfied within a matter of days and may state or imply that this is expected to be the case going forward.

1.7 There is a risk that investors in these schemes may consider their investments to be liquid without properly appreciating that the responsible entity may refuse to allow withdrawal until after a long period of time has expired. Therefore, if a constitution provides for a long withdrawal period but the scheme is marketed on the basis that the responsible entity has a practice of satisfying withdrawal requests within a much shorter period, it must be made clear to investors that the responsible entity does not have an obligation to satisfy withdrawal requests within the shorter withdrawal period.

Statements about future withdrawal periods

1.8 If a responsible entity does not have reasonable grounds for making a representation about a future matter, that representation is taken to be misleading: s769C. When a responsible entity represents, expressly or impliedly, that it expects to be able to satisfy withdrawal requests within a particular period, it must have reasonable grounds to make that representation taking into account how the range of persons receiving the representation may interpret it.

1.9 Policy Statement 170 *Prospective financial information* [PS 170] gives guidance on what will be reasonable grounds for representations about prospective financial information. Much of this guidance is also relevant to whether there are reasonable grounds for a statement about the expected period for satisfying withdrawal requests. This is because the same risk that retail clients will misinterpret projections of future

events applies. We consider that generally when making representations to retail clients about their future ability to withdraw:

- (a) there must be verifiable grounds for the statement;
- (b) the statement must not be supported only by hypothetical assumptions;
- (c) the statement must not be based only on an opinion of the directors of the responsible entity if there are no objective grounds to support that opinion; and
- (d) the responsible entity should disclose any significant risk factors that mean that withdrawal requests might not be satisfied within the expected period.

1.10 If a PDS contains a statement that historically withdrawal requests have been satisfied within a particular period, this may suggest a link between historic periods for satisfying withdrawal requests and withdrawal periods that are likely to apply in the future. Care must be taken to ensure that investors do not conclude that there is such a link if none is intended.

Establishing reasonable grounds

1.11 We propose that the following factors are relevant to whether there are reasonable grounds for a statement about expected future withdrawal periods:

- (a) the length of the expected future withdrawal period;
- (b) a model of expected future cash flows of the scheme, including:
 - (i) the historic and anticipated level of withdrawal requests;
 - (ii) the proportion of scheme interests for which withdrawal requests cannot be made before a particular date;
 - (iii) the proportion of scheme interests for which withdrawal requests can be made immediately;
 - (iv) the nature of scheme assets, including, for pooled mortgage schemes, the maturity dates of any mortgage loans; and
 - (v) any contracts that lock in payment of expenses and revenue such as distributions to scheme members and, in the case of pooled mortgage schemes, payments of interest and capital on mortgage loans;
- (c) the sensitivity of the future cash flow model in paragraph (b) to changes in its underlying assumptions;

- (d) the proportion of scheme assets that are to be held in cash or that can be readily realised for cash or used as security to borrow;
- (e) for assets that cannot be readily realised for cash, the expected realisation periods for those assets;
- (f) the extent of any reliance upon an audit or review by an independent expert of the matters referred to in paragraphs (a)–(e); and
- (g) the systems that the responsible entity has in place to monitor and manage liquidity risks.

This list is not exhaustive.

Note: Although cash flows are not relevant for determining whether a scheme is liquid for the purposes of Pt 5C.6, it is likely that a model of cash flows will help a responsible entity determine whether it has a reasonable basis for statements about future withdrawal periods.

Your feedback

- Q1.2** Are there any other factors that should be considered when determining whether there are reasonable grounds for a statement about expected future withdrawal periods?
- Q1.3** Other than pooled mortgage schemes, are there any schemes that are marketed on the basis that withdrawal requests will be satisfied within a much shorter period than that specified in the constitution? Are there any special considerations for these schemes?

Disclosures about liquidity

1.12 Unless a scheme is liquid for the purposes of Pt 5C.6, members will only have a right to withdraw under withdrawal offers made to them in accordance with the procedures set out in s601KB–601KE. If a responsible entity states that it is likely that, or it expects that, a scheme will be liquid for the purposes of Pt 5C.6, it must have reasonable grounds for making such a statement: s769C.

1.13 We propose that the following factors are relevant to whether there are reasonable grounds for making a statement about the likely future liquidity of a scheme for the purposes of Pt 5C.6:

- (a) the withdrawal period specified in the constitution;
- (b) the types of property the scheme holds and is likely to hold in the future;
- (c) the extent to which there is a market for each type of scheme property and the nature of any market;

- (d) based on the market for each type of scheme property:
 - (i) the market value of scheme property; and
 - (ii) the time within which the responsible entity might reasonably expect to be able to realise scheme property for its market value;
- (e) how sensitive the liquidity of the scheme is to changes in the factors in paragraphs (a)–(d);
- (f) the extent of any reliance upon an audit or review by an independent expert of the matters in paragraphs (a)–(e); and
- (g) the systems which the responsible entity has in place to monitor and manage liquidity risks.

This list is not exhaustive.

Your feedback

Q1.4 Are there any other factors that should be considered when determining whether a scheme is likely to be liquid for the purposes of Pt 5C.6?

Application to pooled mortgage schemes

1.14 Justifying forward looking statements about expected withdrawal periods or future liquidity may present greater difficulties for pooled mortgage schemes than for many other schemes due to the special characteristics of these schemes. Some factors in paragraphs 1.11 and 1.13 are likely to require particular attention for a pooled mortgage scheme, including:

- (a) the construction of a model of future cash flows; and
- (b) whether mortgage loans held by the scheme are liquid assets, given the ability of the responsible entity to realise mortgage loans for their market value and the time this is likely to take.

1.15 The responsible entity of a pooled mortgage scheme should carefully consider whether it needs to obtain a review by an auditor or independent expert in order to have reasonable grounds. It is more likely that an auditor or independent expert will need to be involved where:

- (a) the responsible entity's assessment of the market for mortgage loans held by the scheme is not based on recent sales of, or expressions of interest in, similar mortgage loans;
- (b) there are factors which mean that such sales or expressions of interest are not relevant to the circumstances of the scheme;

- (c) the responsible entity is uncertain whether all of the assumptions underlying its assessment of the market for mortgage loans or its model of cash flows are objectively reasonable;
- (d) there is only a small margin for error in the responsible entity's assessment of whether the scheme is likely to be liquid or whether particular withdrawal periods are likely to be met in the future; or
- (e) the responsible entity has only considered liquidity and withdrawal periods in a narrow range of circumstances and has not taken into account whether statements about liquidity and withdrawal periods will continue to be correct should there be variations in factors such as the level of cash inflows and outflows and the strength of the market for mortgage loans.

Your feedback

Q1.5 When is it reasonable to expect that the responsible entity of a pooled mortgage scheme would obtain an audit or independent review of its assessment of future withdrawal periods or future liquidity before making representations about these matters?

Q1.6 What would be the typical cost of obtaining an audit or independent review to justify statements about expected withdrawal periods or future liquidity?

Changes in circumstance

1.16 The responsible entity may need to issue a supplementary PDS or a new PDS if:

- (a) the basis for a statement in a PDS about expected withdrawal periods or liquidity has changed; or
- (b) historic information contained in the PDS may have become misleading.

As a matter of good practice, the responsible entity should ensure that existing investors are made aware of any material change in circumstances. It may also have an obligation to give notice of a change in circumstances under Ch 6CA, s1017B or s1017D.

Your feedback

Q1.7 When is it reasonable to expect the responsible entity of a pooled mortgage scheme to notify members of a material change in current expected withdrawal periods or scheme liquidity? Is it sufficient to make this information available for example on a website or should it be drawn to members' attention? In what kinds of situation will a change in circumstances need to be disclosed under the Act?

Advertising and other representations

1.17 Representations about a scheme may be made in advertisements or by persons promoting the scheme to investors. Persons responsible for making such representations must ensure that:

- (a) the representation is not misleading or deceptive or likely to mislead or deceive; and
- (b) if the representation is about a future matter, such as future liquidity or withdrawal rights, the person has reasonable grounds for making the representation.

These requirements apply to all representations made when promoting a scheme, not just representations in a PDS.

1.18 It is important that advertisements and other representations do not lead investors to draw incorrect conclusions about scheme liquidity or their ability to withdraw from the scheme. That is the case regardless of whether there is adequate disclosure of liquidity and withdrawal rights in the PDS for the scheme.

Your feedback

Q1.8 Does the proposed guidance in this section about disclosure of scheme liquidity and withdrawal rights reflect current market practice?

Q1.9 If any of our proposals do not reflect current market practice, please provide details of:

- (a) those aspects of our proposals that depart from current market practice; and
- (b) the amount and nature of any additional costs that would be incurred by responsible entities in operating schemes in accordance with our proposals.

Section 2: Monitoring and managing liquidity risks

2.1 This section sets out our proposed guidance on what systems responsible entities should have in place to monitor and manage liquidity risks. It also discusses some specific issues that may arise when managing liquidity risks.

Duties of a responsible entity

2.2 There may be a number of liquidity risks associated with a scheme. These can include risks that:

- (a) the scheme will cease to be liquid for the purposes of Pt 5C.6; and
- (b) members will not be able to withdraw from the scheme within the period represented to members.

2.3 We consider that in properly performing its duties, the responsible entity of a scheme for which there may be liquidity risks will need to:

- (a) have in place systems and processes which enable it to monitor and manage these risks;
- (b) ensure that in managing these risks, it:
 - (i) acts in the best interests of members; and
 - (ii) treats members of the same class equally and members of different classes fairly; and
- (c) ensure that members are kept adequately informed about any material change to the liquidity of the scheme or liquidity risks.

2.4 Schemes for which liquidity risks are a significant issue will need to place a greater emphasis on monitoring and managing these risks than schemes for which liquidity risks are a lesser concern. For example, a pooled mortgage scheme that promotes the ability of members to withdraw on a few days notice will need to pay special attention to monitoring and managing liquidity risks due to the discrepancy between the advertised withdrawal period and the time needed to realise mortgage loans held by the scheme.

Monitoring liquidity risks

2.5 The responsible entity of a scheme for which there may be liquidity risks will generally need to monitor liquidity and liquidity risks on an ongoing basis. The reasons for this include:

- (a) the responsible entity may need to issue a supplementary PDS or a new PDS or give notice to existing investors if disclosures about liquidity or withdrawal rights are no longer correct;

- (b) subject to its other duties, a responsible entity that has made representations to investors about the liquidity of a scheme or withdrawal rights should monitor and manage liquidity risks to ensure that it can meet these representations;
- (c) each time a member makes a withdrawal request, the responsible entity will need to consider whether the scheme is liquid so that it can determine how to deal with the withdrawal request; and
- (d) the responsible entity will only be able to satisfactorily manage liquidity risks if it monitors scheme liquidity and liquidity risks.

2.6 In monitoring liquidity and liquidity risks, responsible entities will generally need to consider the matters in paragraphs 1.11 and 1.13. The responsible entity of a pooled mortgage scheme should consider the matters in paragraph 1.15 when determining whether its assessment of liquidity and liquidity risks should be reviewed by an auditor or independent expert.

Your feedback

Q2.1 Should a responsible entity consider the same matters when monitoring liquidity risks as it needs to consider when making representations about the future liquidity of a scheme or future withdrawal periods that will apply to the scheme?

Managing liquidity risks

2.7 We propose that the steps a responsible entity may need to take to manage liquidity risks include:

- (a) reviewing and updating the scheme's procedures for monitoring liquidity;
- (b) adjusting the proportion of the scheme's assets that are held in cash or assets that are readily convertible into cash;
- (c) realising scheme property for its market value;
- (d) in the case of a pooled mortgage scheme, ensuring that the maximum term of any new mortgage loans is not overly long having regard to liquidity requirements;
- (e) applying reasonable and appropriate criteria in exercising a discretion about withdrawal requests and considering the interests of continuing members in exercising such a discretion;
- (f) if it issues new interests in the scheme, considering whether investors must hold those new interests for a particular period before being able to withdraw from the scheme;

- (g) considering whether the scheme should borrow or repay borrowings; and
- (h) considering when other payments, such as fees and expenses, or costs arising from assets held must be made and when income may be expected.

Your feedback

Q2.2 Are there any other steps that pooled mortgage schemes might take to manage liquidity risks?

Other issues

2.8 A responsible entity must be careful that in managing liquidity risks and implementing any of the above steps it acts in the best interests of members. There may be circumstances in which maintaining the liquidity of a scheme is not in the best interests of members. That will be the case if the detriment to members of the scheme becoming illiquid is outweighed by the detriment to members of any preventative action that the responsible entity could take to keep a scheme liquid.

2.9 For example, the responsible entity of a pooled mortgage scheme could maintain liquidity in the short term by selling mortgage loans for less than their market value or by borrowing funds on unfavourable terms or that inappropriately increases the risk for investors. It is unlikely that these actions will be in the best interests of members even if they maintain the liquidity of the scheme.

2.10 Responsible entities must act in the best interests of the members collectively and ensure that they treat members of the same class equally and members of different classes fairly when managing liquidity risks.

2.11 Some schemes are operated on the basis that a shorter withdrawal period can apply in practice than the withdrawal period provided for in the scheme constitution: see paragraphs 1.6–1.7. Where a responsible entity has the discretion to satisfy withdrawal requests within a shorter period than specified in the constitution, the responsible entity must consider the interests of continuing members before exercising that discretion and must apply reasonable and appropriate criteria in exercising that discretion. It will usually be appropriate to document the criteria to demonstrate the responsible entity is performing its duties. Disclosure of the criteria in a PDS or notice under Ch 6CA, s1017B or s1017D may be required.

2.12 When assets are sold to fund withdrawal requests, any sale must be carried out in a way that does not unfairly disadvantage remaining

members. The responsible entity should consider the interests of continuing members when determining which assets to sell and the terms of the sale. If this is not done, there is a risk that the most marketable scheme assets will be sold first, reducing the overall quality of scheme assets and prejudicing the ability of continuing members to withdraw.

2.13 When money is borrowed to fund withdrawal requests, it must be in the interests of members generally and consistent with representations made in any PDS about the responsible entity's policy on borrowing. Increased borrowing increases the potential volatility of investment returns and this may not be consistent with members' expectations or best interests.

Your feedback

Q2.3 Does the proposed guidance in this section about monitoring and managing liquidity risks reflect current market practice?

Q2.4 If any of our proposals do not reflect current market practice, please provide details of

(a) those aspects of our proposals that depart from current market practice; and

(b) the amount and nature of any additional costs that would be incurred by responsible entities in operating schemes in accordance with our proposals.

Section 3: Proposed relief for multiple withdrawal periods

3.1 We are aware that certain constitutions currently provide for multiple withdrawal periods to operate at the one time. This is not permitted under Pt 5C.6: see paragraphs 9–10 in the Appendix.

3.2 We propose to give relief to allow constitutions the flexibility to provide for multiple withdrawal periods. Providing such relief would be consistent with the position that members may generally have different withdrawal rights as long as one group of members is not unreasonably disadvantaged: see Policy Statement 134 *Managed investments: Constitutions* at [PS 134.25].

3.3 We propose to provide relief by modifying Pt 5C.6 so that where there is more than one withdrawal period, the shortest withdrawal period would be the relevant withdrawal period for the purpose of the liquidity test in s601KA.

3.4 The proposed relief would be conditional on the responsible entity publishing a statement that it is relying on this relief.

3.5 Until we have announced our final decision on the proposed relief, we will take a no-action position on constitutions that currently provide for multiple withdrawal periods. This no-action position will only apply to a scheme if the responsible entity determines scheme liquidity on the basis that the shortest withdrawal period is the relevant withdrawal period for the purposes of the liquidity test in s601KA.

Your feedback

Q3.1 Should we grant relief to allow scheme constitutions to provide for multiple withdrawal periods? Would allowing multiple withdrawal periods raise any investor protection issues?

Q3.2 If relief is provided, what conditions should apply? Should the test for whether a scheme with multiple withdrawal periods is liquid be based on the shortest withdrawal period specified in the constitution? Would this be consistent with current market practice? If not please give details on the amount and nature of any additional costs that would be incurred by responsible entities in operating schemes in accordance with our proposals.

Section 4: What happens next?

Regulatory and financial impact

4.1 We have carefully considered the regulatory and financial impact of the policy proposals in this paper. Based on the information that we currently have, we believe that our proposals strike an appropriate balance between facilitating financial services relating to managed investment schemes and the risks to members and prospective members of those managed investment schemes.

4.2 Before settling on our final policy, we will comply with the requirements of the Office of Best Practice Regulation (OBPR) by:

- (a) considering all feasible options;
- (b) undertaking a preliminary assessment of the impacts of the options on business and individuals or the economy if regulatory options are under consideration;
- (c) consulting with OBPR to determine the appropriate level of regulatory analysis if our proposed option has more than low impact on business and individuals or the economy; and
- (d) if our proposed option has more than low impact, conducting the appropriate level of regulatory analysis, that is, completing a Business Cost Calculator report (BCC report) and/or a Regulation Impact Statement (RIS).

4.3 All BCC reports and RISs are submitted to the OBPR for approval before we make any final decision. Without an approved BCC report and/or RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.

4.4 To ensure that we are in a position to properly complete any required BCC report or RIS, we ask you to provide feedback as requested in the previous section and generally provide us with as much information as you can for our proposals or any alternative approaches about:

- (a) the likely compliance costs;
- (b) the likely effect on competition; and
- (c) other impacts, costs and benefits.

Note: See 'The consultation process' at the beginning of this paper.

Development of final policy

4.5 We plan to publish our final policy by December 2007, after considering any comments or feedback you send us on these proposals.

Appendix: Regulation of withdrawal rights

1 This appendix summarises the regulatory regime applying to withdrawal rights and deals with some of the technical issues that may arise when determining whether a scheme is liquid for the purposes of Pt 5C.6. It also discusses some reasons why the responsible entities of pooled mortgage schemes may need to pay special attention to the disclosure and management of liquidity issues.

Registered schemes

2 Part 5C.6 of the Act sets out the circumstances in which members can withdraw from a registered scheme. Although a scheme's constitution may make provision for how members may withdraw, unless a scheme is liquid, members can only have a right to withdraw under withdrawal offers made to them in accordance with the procedures set out in s601KB–601KE. It is therefore important for a responsible entity to be able to determine whether a scheme is liquid and to ensure that adequate disclosure is made to investors about scheme liquidity and withdrawal rights.

3 A scheme is liquid if liquid assets account for at least 80% of the value of scheme property. Certain prescribed assets (such as money with a bank and marketable securities) are liquid assets unless the responsible entity cannot reasonably expect to realise them within the period specified in the constitution for satisfying withdrawal requests. Any other property is a liquid asset if the responsible entity reasonably expects that the property can be realised for its market value within that period: s601KA.

4 ASIC considers that when determining the value of scheme property and the value of liquid assets for the purposes of the liquidity test in s601KA, liabilities of the scheme should only be taken into account if they are attached to a particular item of scheme property. For example, the right to occupy property under a lease is scheme property that cannot be enjoyed without performing obligations under the lease, in particular the obligation to pay rent. In this case, the value of the right to occupy the lease should not be valued without reference to the obligations that must be performed in order to enjoy that right. However, liabilities that do not attach to a particular item of scheme property (e.g. a debt) should not be taken into account when determining whether a scheme is liquid.

5 We note that the right to draw down funds under a loan facility is likely to have little value for the purposes of the test in s601KA. That is because the value of the right to draw down funds is the value of those funds less the value of the liabilities that will be assumed on drawdown. Accordingly, any value attributed to the right to drawn down funds needs to take into account the offsetting liability to repay those funds, together with interest, once they are drawn down.

Pooled mortgage schemes

6 In this consultation paper, references to a mortgage scheme are to a unit trust that invests a substantial proportion of its assets in loans secured by mortgages over residential, commercial, industrial or retail property or vacant land. For the purposes of this consultation paper, we are principally concerned with pooled mortgage schemes, being mortgage schemes that operate on the basis that:

- (a) investors' money is pooled and lent by the trustee to various borrowers, with those loans secured by mortgages; and
- (b) investors do not have an interest in a particular mortgage loan, but have an interest in scheme property as a whole.

Pooled mortgage schemes are likely to be managed investment schemes. Subject to s601ED, they must generally be registered and comply with Ch 5C, including Pt 5C.6 relating to withdrawal from a registered scheme.

7 The constitutions of many pooled mortgage schemes provide for a withdrawal period of several months. A mortgage loan will be a liquid asset if the responsible entity reasonably expects that it can realise the mortgage loan for its market value within the withdrawal period specified in the constitution: s601KA(6). Responsible entities of pooled mortgage schemes with withdrawal periods that are several months long sometimes take the view that a substantial proportion of mortgage loans are liquid assets for the purposes of those schemes. Given the nature of mortgage loans, it is likely to be difficult for a responsible entity to demonstrate that a pooled mortgage scheme is liquid if the scheme constitution provides for a relatively short withdrawal period. The main body of this paper includes our proposals as to some of the factors that responsible entities should consider when determining whether a scheme is liquid.

8 Pooled mortgage schemes whose constitutions provide for long withdrawal periods are often marketed on the basis that withdrawal requests are likely to be satisfied within a few days or a much shorter period than the withdrawal period in the constitution. The responsible entities of such schemes will need to pay special attention to the disclosure and management of liquidity issues due to:

- (a) the discrepancy between when investors may think they will be able to withdraw and permitted withdrawal periods;
- (b) the risk that mortgage loans will generally not be able to be realised within the period marketed to investors as the time within which they can withdraw;
- (c) the need to have reasonable grounds for statements about expected withdrawal timeframes;

- (d) the expectations members will have about their withdrawal rights; and
- (e) the need to ensure that where the responsible entity has a discretion in relation to withdrawal requests (e.g. a discretion to satisfy withdrawal requests within a shorter period than provided for in the constitution), it applies reasonable and appropriate criteria in exercising the discretion and considers the interests of continuing members when deciding if it should exercise the discretion.

These issues are discussed in the main body of this paper.

Multiple withdrawal periods

9 A scheme is liquid if 80% of the scheme's assets can be realised within the *period* specified in the constitution for satisfying withdrawal requests while the scheme is liquid: s601KA.

10 If a constitution provides for more than one withdrawal period to apply at the same time (e.g. because there are different classes of interests on issue), there is no definitive answer to whether a scheme is liquid and therefore the provisions of Pt 5C.6 cannot sensibly operate. This means that Pt 5C.6 does not permit a constitution to provide for more than one withdrawal period to apply at any one time.

Variable withdrawal periods

11 Some constitutions provide for a withdrawal period that varies depending on particular circumstances. For example, a constitution may state that a withdrawal period is generally 3 months, but is 6 months if cash represents less than a specified percentage of scheme assets.

12 The fact that a constitution provides for a variable withdrawal period does not necessarily offend the requirement implicit in s601KA that a constitution may only provide for a single withdrawal period. However, at any given time there must only be one withdrawal period for all interests and it must be possible to ascertain what that period is.

Fixed term investments

13 Some pooled mortgage schemes offer 'fixed term investments' which require investors to notify the responsible entity a specified time before the end of the fixed term if they wish to withdraw. For example, a withdrawal provision may operate so that:

- (a) investments will be rolled over unless the investor gives notice of withdrawal at least 30 days prior to the end of the fixed term; and
- (b) if notice of withdrawal is given, the responsible entity must satisfy the withdrawal request within 60 days after the end of the fixed term.

14 If an investor is required to give notice in order to withdraw, the investment is essentially in the nature of an ongoing investment even though it may be promoted as a 'fixed term investment'. The withdrawal period for such investments is the minimum period within which the responsible entity might be required to satisfy a withdrawal request. Therefore, for the above example, the withdrawal period would be 90 days and scheme liquidity for the purposes of Pt 5C.6 would be determined on the basis of this withdrawal period.

Key terms

In this paper, unless a contrary intention appears, the following terms have the following meanings:

Act The *Corporations Act 2001* including regulations made for the purposes of the Act.

ASIC The Australian Securities and Investments Commission.

mortgage loan A loan secured by a mortgage over residential, commercial, industrial or retail property or vacant land.

mortgage scheme A unit trust that invests a substantial proportion of its assets in mortgage loans.

pooled mortgage scheme A mortgage scheme that operates on the basis that:

- (a) investors' money is pooled and lent by the trustee to various borrowers, with those loans secured by mortgages; and
- (b) investors do not have an interest in a particular mortgage loan, but have an interest in scheme property as a whole.

PDS A Product Disclosure Statement.

[PS 170] (for example) An ASIC policy statement (in this example numbered 170).

s601KA (for example) A section of the Corporations Act (in this example numbered 601KA).