THE MANAGED INVESTMENTS ACT - UPDATE

ALAN CAMERON, AM
CHAIRMAN
AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

TRUSTEE CORPORATIONS ASSOCIATION OF AUSTRALIA

Remarks prepared for the
National Council Luncheon

Hotel Inter-Continental, Sydney

31 March 2000

Introduction

It is a pleasure to address the Trustee Corporations Association of Australia once again. On previous occasions I have addressed what were, at the time, current issues of regulation affecting the Association. None of those issues however would have had as significant an impact on the membership of the Association as the topic for discussion today. That topic is, of course, an update on Managed Investments: the approaching end of the transition period; where ASIC is up to with the implementation of the new legislation; what ASIC has experienced to date as a result of the legislation, including a look at such things as mortgage investment schemes and serviced strata schemes, which have needed to comply with the new regime and investor directed portfolio services.

It is important to note also that the implementation of the managed investments legislation has not occurred in a vacuum. CLERP arrived on March 13 and the consumer protection regime has also taken effect, both of which have impacted on Managed Investments. The current volatility and complexity of the market with a growing number of confident Australian shareholders and a boom in high tech stocks have also made an impact as has the current debate over the constitutional validity of the Corporations Law: all are worthy topics for discussion.

The end of the transition period

Despite the saying that there are lies, damn lies and then there are statistics, in order to give you an idea of how the transition is progressing, allow me to present you with some figures. According to the Commission's latest figures, there are approximately 20% of funds which have not yet made the transition to comply with the new regime. Of that 20%, ASIC is aware that approximately half are at least aware that the transition must be made. Given that there is only 3 months left in which to make the transition, Trustees should be pressuring any Fund Managers in this position to take action. Since the Managed Investments Act came into effect, scheme operators have had 21 months in which to ensure their scheme is brought into compliance with the legislation. It is rather concerning that it appears that 20% of funds still have not yet made the transition or even commenced the transition process. The deadline of 30 June 2000 will not be extended. But the slightly better news is that some at least of those which have done nothing, have done nothing. That is, they are dormant.

ASIC has attempted to ensure that all prescribed interest schemes have been notified of the requirement to comply with the new Act. Those that still need to meet the requirements must make both an application for a responsible entity licence. As you all know, this is not merely a "rubber stamp process". An application to register the relevant scheme or schemes, and a compliance plan and constitution then need to be lodged before registration can take place. This process of transition, as many of you would know, can take a number of months as many operators need to update their compliance systems in order to conform with the new law. If a scheme is not compliant by 30 June 2000, either through failure to lodge the relevant applications in sufficient time, or for any other reason, ASIC will have no option but to treat that scheme as illegal and take action to close it down.

Compliance with the Managed Investments Act is a legal requirement, and ASIC will provide scheme managers with all the assistance we can to ensure they are on track to achieve it, provided that steps are taken to achieve registration in a timely manner.

Particularly after the deadline for this last transitional period passes at the end of June, the time will come for the Commission to step in where responsible entities are acting inappropriately. When this time arrives, it may be necessary to appoint a temporary RE to operate schemes where the existing RE's license has been revoked. There is no statutory arrangement in place for finding such a temporary RE. Obviously the basic requirement for an entity to be a temporary RE would be the holding of a license. There have been 2 occasions such as this arise, but in both of those situations, ASIC was able to rely on an entity which had a role in the scheme (ie the custodian) to step in as the temporary RE. An ongoing issue is what mechanism can be put in place to identify a pool of REs that prepared to act as a temporary RE should the need arise. The Commission would be very happy to receive any feedback on this idea from individual trustee companies.

From Trustees to Custodians

Through this transitional process, whilst the roles of trustees as we knew them have disappeared, many trustees have taken on a continuing role, in a different capacity, either as custodians or as responsible entities. Trustees wearing the custodian's hat however, must realise that there is a different relationship between the RE and the custodian than existed between the Trustee and the Fund Manager. This different relationship will drive many practical changes including how and when instructions are executed, and to whom duties are owed, and could possibly give rise to a different liability profile for the custodian. It is also hoped that those changes would create different cost profiles. It may be the case that changing from a 2 party to a 1 party structure will translate into a transactional cost saving, although that is still to be determined.

The legislation is due for review in its third year although exactly when that review will take place and who will be doing it are still unknown. It is expected however that that review process will include a review of the costs and benefits of the legislation, including transactional costs.

ASIC is aware that both trustees and responsible entities have needed to work together to establish a new working relationship between them when the Trustee becomes a custodian. Trustees should be aware though that the onus is very much on the RE to ensure that it is satisfied that the custodian is complying with ASIC standards for holding scheme property as detailed in Policy Statement 133. This means that the parties should be placing reporting requirements in the custodian agreements in order to reflect, in the agreement, the changed relationship between the custodian and the RE. ASIC's policy statement 133 sets out in broad terms, what the Commission thinks should be contained in that agreement.

The agreement should clearly cover:

(a) the scope and expectations of the relationship;

(b) any rights in relation to ongoing review and monitoring of the agent and the standards against which that agent's performance will be assessed;
(c) how the agent will provide assurances that it meets the standards set out in this policy statement;
(d) how authorised instructions to the agent will be given;
(e) how the scheme will be compensated if there is a loss to the scheme as a result of the agent failing in its obligations under the agreement and the extent to which the custodian must maintain a minimum level of professional indemnity insurance;
(f) that the agent is prohibited from taking any charge, mortgage, lien or other encumbrance over, or in relation to, assets of the scheme. They may, however, do this for expenses and outlays made within the terms of the agreement (but not including unpaid custodian fees);
(g) what should be in the written agreement between the agent and any sub-custodians used. A written agreement should be in place when practicable. The agreement should cover, to the extent practicable and relevant, the same issues which should be covered in the agreement with the agent. The agreement should also cover the liability of the sub-custodian to the responsible entity and the agent when acts or omissions of the sub-custodian make them liable;
(h) how records identifying the scheme's assets will be maintained; and
(i) how and when periodic reports will be received, including notifications of any transfers to, or from, the scheme's account.

A custodian of scheme property, whether it is the responsible entity or its agent must meet standards on:
(a) organisational structure;
(b) staffing capabilities;
(c) ability and resources to perform core administrative activities;
(d) arrangements on how various assets are held; and
(e) custody-related capital which are detailed in Policy Statement 131.

A responsible entity which does not meet these standards will still be given a licence if it meets our other licensing requirements. However, its licence will be subject to a condition that another entity which meets the standards must be custodian of all the property of any scheme which the responsible entity operates.

The Law highlights the importance which is placed on the arrangements that the responsible entity will put in place to ensure proper standards for the safe keeping of scheme property. We believe that members' interests will be better protected if the scheme property is held only by entities, responsible entities or custodians on their behalf, which meet minimum standards. Our standards seek to ensure that :
(a) scheme property is not exposed to unnecessary risks because of the way it is held; and
(b) efficient operational arrangements exist for holding and dealing with scheme property.

While on the subject of custody it should be noted that after industry consultation and discussions with ASIC, APRA has recently issued its custodian requirements. The requirements reflect the importance of regulator consistency in this area. Feedback to date indicates that this has been well received by custodians generally. Many custodians of managed investment funds will, of course, also be custodians of superannuation funds. This collaboration between ASIC and APRA will continue not only in relation to structural and organisational standards, but we are also working carefully to ensure that our capital requirements are as close as possible.

Responsible entities can of course be their own custodian so long as they meet ASIC's requirements on structure, staffing capabilities, resources and arrangements on how assets are held. Our database shows, however, that approximately 85% of responsible entities are choosing to outsource their custodian activities. ASIC is not concerned by this arrangement so long as responsible entities remain cognisant of the fact that the RE remains liable for the actions of their agent.

From Trustees to REs

There are a number of trustees that have applied to become REs. Some have set up REs so they can provide their own schemes while other have also set themselves up as an "RE for hire" or what ASIC calls a "special purpose RE".

ASIC congratulates trustees that take on these obligations, as "REs for hire" provide a valuable service to the industry. A word of warning though: the relationship between an RE and a promoter is an entirely different relationship from that of a trustee and a fund manager.

ASIC expects a great deal more due diligence and compliance monitoring and reporting with this new relationship. ASIC understands that both trustees and fund managers will find this a challenge. In particular fund managers may not welcome the high level of obligation to the RE. I suppose the key message here is that ASIC does not expect it to be business as usual, but for both parties to undergo some major review of their relationship.

Implementation of the new regime

Implementation of the new regime has produced a few surprises for both industry participants and for the regulator. Our resources have been tested continuously, (and will continue to be tested in the future as the deadline approaches and still there are a number of funds to make the transition), but particularly resources have been tested in relation to ensuring the compliance of a great number of smaller operators of funds which amount to managed investment schemes under the legislation. One of our aims has been to determine what fund managers, both small and large, have put in place to ensure they meet their new fiduciary and compliance obligations under the Managed Investments Act. Mortgage investments schemes and serviced strata schemes, to the extent that they fell within the old prescribed interest legislation, remain subject to the managed investment regime and have been a particular challenge. A number of operators of these schemes don't necessarily have a background understanding of compliance or of the Corporations Law in relation to structural obligations or in relation to fundraising, or even in relation to licensing requirements. A major cultural shift has been required which takes a great deal of effort to drive. Our team has produced 2 clear policy statements on these topics to assist scheme operators with that shift: policy statement 144 in relation to mortgage investment schemes and policy statement 140 regarding service strata schemes.

Mortgage Investment Schemes

Our general policy when regulating mortgage investment schemes or solicitor's mortgage lending schemes as they are sometime referred to, is that:

(a) if you operate a mortgage scheme that is a managed investment scheme you must comply with Chapter 5C of the Corporations Law;

(b) in most respects, we apply the policies we have adopted for other managed investment schemes to mortgage scheme operators but in some areas we provide relief specific to mortgage scheme operators;

(c) we have eliminated one source of legal uncertainty by making the business of providing mortgage investment services the focus of our regulation, not individual mortgages;

(d) if you are the operator of a small industry supervised scheme we will allow you to comply with an approved industry body's rules rather than all of Chapter 5C. We allow this if the industry body can supervise such schemes effectively and if appropriate insurance arrangements are in place;

(e) although we require prospectuses for all regulated mortgage investment schemes, we allow the use of a two-part prospectus, so that private details about a borrower can be kept off the public register. This relief continues to be available pursuant to the prospectus provisions in Chapter 6D came into effect under the CLERP Act on 13 March 2000.

Our policy is designed to permit appropriate investment choices while ensuring adequate and effective consumer protection.

Whether or not a mortgage investment scheme will amount to a managed investment scheme will depend on how the business is carried out. Our approach to how the definition of managed investment schemes applies to mortgage investment services has two elements:

(a) the nature and extent of the activities of the mortgage investment services provider is critical and must be viewed as a whole and in their full commercial context; and

(b) our policy that the focus of regulation should be on the service provider rather than the individual mortgage.

In relation to the activities of the mortgage investment service provider, the following key factors are relevant to whether Chapter 5C applies to a scheme:

a) the extent to which the legal or commercial character of the investment depends on the business or operations of the promoter. For example:

    (i) if discrete interests in contributory mortgages are pooled and money contributed by different investors is lent under one mortgage. This strongly indicates the characteristics of a managed investment scheme (unless the money is jointly managed or invested for reasons other than investment in the mortgage scheme);

    (ii) if mortgages are taken in the name of the nominee for one investor. This is less clear-cut, but may indicate the characteristics of a managed investment scheme, if it is done to facilitate management or transfer the investor's interest;

    (iii) if the availability of borrowers, securities or particular terms depends on the scale and continuity of your business. This may also indicate the characteristics of a managed investment scheme;

b) the extent to which commercial decisions are taken by the operator or the promoter of the scheme, and not by investors. This must be a matter of fact and degree in each case. But it seems to us that the most important factor is who takes the commercial decisions, and not, for example, who acts as a postbox or draws up documents to implement a decision, once made. For example:
    (i) if you routinely make investment decisions under general authority, or decide whether to extend loans or enforce securities, without referring decisions to investors. This strongly indicates the characteristics of a managed investment scheme (contributory mortgages are generally managed in this way, but not all nominee mortgages are);
    (ii) if you are responsible for obtaining, or determining valuation and approving lending against those valuations, or administering a repayment system. This suggests a managed investment scheme;
    (iii) conversely, if a solicitor documents a security and settles an advance under the instructions of a person who makes their own bargain. This does not give the transaction the characteristics of a managed investment scheme;

c) whether the scheme attracts section 601ED which provides that a scheme must be registered if it has 20 or more members or was promoted by a person…who was, when the scheme was promoted, in the business of promoting managed investment schemes.

We are issuing a media release next month in order to provide even more certainty in this area.

Serviced Strata Schemes

Our policy on serviced strata schemes or strata title schemes, as they are also called, is that they must comply with the managed investment, fundraising and licensing provisions of the Corporations Law. In general we consider that there is likely to be a serviced strata scheme when an investor's right to a return depends (totally or partially) on either or both of the following two factors:

- the use of other investors' strata units; or
- the use of their strata unit as part of a hotel, motel, resort or serviced apartment complex.

An investor that has an understanding with a promoter that they will get the return is treated as having a right to that return.

We have given promoters and operators of some types of serviced strata schemes conditional relief from the Corporations Law. This means that if you operate a scheme of this type (or offer interests in a scheme) you may not have to comply with some, or all, of the managed investment, licensing and fundraising provisions of the Corporations Law.

This relief is given in "class orders" or in some circumstances on a case by case basis under a "pro forma". In order to obtain the benefit of relief under a pro forma one must apply for relief in relation to a particular scheme. One does not need to apply for relief if there is a class order. The class order and pro forma are however, conditional. This means that the conditions listed in any relevant class order or pro forma must be met in order to take advantage of the relief.

We have given relief and will give relief from some or most of the provisions of the Corporations Law if appropriate when:

(a) strictly complying with the Corporations Law would be impossible or disproportionately burdensome;
(b) people acquiring or holding interests in a scheme would still have the protection that Parliament intended they would have; and
(c) there would be commercial benefit to the parties to the scheme.

Strata arrangements which we are likely to consider to be a serviced strata scheme fitting within the definition of a managed investment scheme is where an investor in a strata unit has a right (including by agreement or an understanding with the promoter) to a return which depends, in whole or in part, on the use of other investors' strata units (as opposed to common property). For example, the investor's return depends on an arrangement for pooling income or for fairly allocating tenants.

There is also likely to be a service strata scheme when an investor in a strata unit has a right (including by agreement or an understanding with the promoter) to a return which depends, in whole or in part, on an investor's strata unit being used as part of a serviced strata arrangement. For example, the investor depends on the serviced strata arrangement to receive some kind of fixed or indexed return.

A serviced strata arrangement is likely to be a managed investment scheme even if one of the situations discussed above exists only after some period during which investors derive returns in some other way, such as, fixed or indexed rent is paid regardless of the success of the operation of a serviced strata arrangement.

A serviced strata scheme may exist although the interests in the scheme are sold as part of a pre-packaged resale of interests. For example, interests initially issued to a promoter or its associate are resold.

A serviced strata scheme is more likely to be found if one or more of the following applies:

(a) the strata units are not suitable for use other than as part of a hotel, motel, resort or serviced apartment complex (including whether or not there are zoning restrictions on the use of the strata units);
(b) nothing is stated about what will happen at the end of a period during which returns do not depend on the use of the units. This is particularly important for short term fixed or indexed return arrangements of up to 5 years;
(c) there is any agreement with each investor that other investors make similar contracts; or
(d) there is pooling of expenses relating to the use of the strata units in a serviced strata arrangement.

Another example of a serviced strata arrangement that we consider is a managed investment scheme is:

(a) a person (buyer) is invited to buy a strata unit from a developer. They are told that they can give an on-site letting agent the right to let, or licence use of, the strata unit;
(b) the buyer is told that the on-site letting agent will operate a serviced apartment arrangement using the strata unit and other strata units made available in a similar

manner. The buyer is also given to understand that they will not be involved in the day to day operation of the arrangement;

(c) the buyer is told that what they are paid by the on-site letting agent will be based on the rent and licence fees received after the on-site letting agent deducts their costs and fees;

(d) the buyer may live in their strata unit or use their own off-site letting agent. Therefore, joining the on-site letting agent's serviced apartment arrangement is voluntary;

(e) the buyer has a right to terminate participation in the serviced strata arrangement on 90 days notice;

(f) buyers come to an explicit (or implicit) understanding with the on-site letting agent about how strata units will be allocated to visitors looking for accommodation. They agree that the operator will allocate units on the basis of what the visitors prefer. However, they also agree that this will be done, as far as possible, in a way that fairly allocates income between the owners of the strata units who join the arrangement.

We believe that schemes that are commercially known as “management rights schemes” in Queensland typically operate along these lines. Therefore management rights schemes are usually managed investment schemes. ASIC has issued, however, Class Order 99/460 which exempts management rights schemes which meet certain conditions, from the managed investment, licensing and fundraising provisions of the Law. This was done as compliance for managed rights schemes with those provisions of the law would be an unreasonable burden. These schemes are usually small, and there would be limited benefit in requiring registration or a prospectus. Investors are unlikely to lose too much from participating in the scheme because they have the option to withdraw (on short notice) their unit and arrange for it to be managed separately. Investors join voluntarily. They will not have been induced to join on the basis of the management expertise of a particular letting agent operator. This is because the ongoing operator (usually the on-site letting agent) can withdraw on limited notice.

It is appropriate that investors get simple but meaningful information about these schemes. The disclosure statement required may form part of, or accompany, any disclosure required under State or Territory legislation about the scheme or strata unit. The requirement for a simple disclosure document protects investors at a reasonable cost.

There are other exemptions for serviced strata schemes set out in Policy Statement 140. Our policy statements in the ASIC Digest, is available free of charge electronically on our website.

I cite examples of such as these, as an indication of the complexity of the issues which have faced the Commission implementing the new regime. Another such example are what are now known as Investor Directed Portfolio Services.

Investor Directed Portfolio Services

These types of services essentially cover 2 existing products, master funds and wrap accounts for which trustees do much administration. A master fund is a trust which invests in other trusts so that investors can access products which normally individual retail investors could not access. For example, bank bills where you need to invest a minimum of $5 million. Service providers who offer investment in a master fund must still, however, provide full disclosure, which can be an onerous obligation, given that more than one investment vehicle is essentially involved.

Following extensive public consultation, ASIC's policy is now final in relation to these services and can be found in Policy Statement 148 which was released on 27 January 2000 and is available on our website.

Investor Directed Portfolio Services ("IDPS") are custody, transactional and consolidated reporting services, often referred to as member discretionary funds and wrap accounts. The IDPS policy is replacing existing policies on member discretionary funds and wrap account. The result will be uniform regulatory treatment of what are essentially functionally similar arrangements, providing market participants with the flexibility to structure their services in a way that best meets their customers' needs.

The policy involves treating IDPS as "services" so they will be regulated under the securities licensing rather than managed investment provisions of the Corporations Law. This does not mean however, that disclosure requirements to investors do not apply. Investors must receive the same disclosure as if they invested directly in the underlying investment products which means they will generally receive a prospectus prior to applying for interests in managed investment schemes.

The use of master funds and wrap accounts as a means of acquiring and holding investments has grown significantly in recent years with commercial developments outgrowing the regulatory framework.   Policy Statement 148 regarding IDPS takes account of industry trends, including the demand for services that substantially operate on an electronic basis.

The main features of the policy are as follows:

- The operators of IDPS are required to hold a securities dealers licence that specifically authorises them to operate an IDPS;
- The managed investment provisions do not apply to an IDPS;
- Clients of an IDPS will receive an IDPS Guide which will contain Advisory Services Guide like disclosure about the IDPS;
- When applying for securities, clients will receive the same disclosure documents (if any) as they would receive if they were applying for interests in managed investment schemes;
- Clients of an IDPS will receive quarterly statements about their transaction, assets, income and expenses or have continuous electronic access to this information;
- Communications between operators and clients will be able to be done electronically;
- Operators of existing member discretionary master funds and wrap accounts have a 13 month transitional period to comply with the policy.
- Ant relief that was applicable to member discretionary funds or wrap accounts will not be applicable to IDPS. People relying on relief under the old policies will have 13 months to comply with the policy from the date it was released in January.

The IDPS policy does not apply to superannuation master funds. These continue to be subject to a separate regulatory regime under the Superannuation Industry (Supervision) Act 1993. We will be considering the possible application of the IDPS policy to superannuation master funds in consultation with industry.

Conclusion

As with any process of change implementation, there are bound to be some growing pains. The Commission has tried to lessen those pains through facilitative transitional arrangements and through the publication of clear policy statements and information releases.

There are still numerous issues which the Commission will continue to grapple with which I have not covered today. Pauline Vamos, whose excellent work in charge of our Managed Investments National Team, and contribution to this paper, I gratefully acknowledge, has drawn my attention to such things as:

- foreign collective investment schemes;
- a policy statement on time share arrangements;
- participating property syndicates;
- a review of the omnibus accounts relief;
- a review of how we look at group of trusts - one or many schemes?
- the impact of loans to members on the calculation of net tangible assets;
- fee prepayment and whether that is permitted by section 601GA
- disclosure of Benchmark Performance in prospectuses; and
- the impact of the Goods and Services Tax on payments to members.

This is a long and not exhaustive list of important changes and issues which will all need to be thoroughly addressed. The Commission is doing its best to provide guidance on these issues through our media and information releases and through our policy statements. We will continue to assist industry through these changes.