SUBMISSION

ASIC Consultation Paper regarding Class Order exemption 02/211 Managed Investment Schemes: interests not for money.

Date

September, 2016

About Grain Producers Australia

GPA is a national Representative Organisation (RO) for the grains industry in accordance with the *Primary Industries and Energy Research Development Act 1989* (PIRD), and has key responsibilities under the *Primary Industries (Excise) Levies Act 1999* and the *Primary Industries (Customs Charges) Act 1999*.

GPA is supported by Grain levy payers in Australia and through direct grower members and state members in Grain Producers SA, VFF Grains Group, NSW Farmers Association, WA Farmers Grains Council, WA Grains Group, Tasmanian Farmers and Graziers and Agforce Grains.

Yours sincerely,

Andrew Weidemann
Chairman
Grain Producers Australia

Introduction
GPA welcomes the opportunity to provide feedback to the Australian Securities and Investment Commission (ASIC) in response to Consultation Paper 266 which, among other things, considers the remake of Class Order *Managed Investment Schemes: Interests not for money* [CO 02/211].

The response below will be solely limited to this class order focusing on its exemption of grain marketing pools from closer oversight by ASIC due to the exemption it provides to the operators of grain pools from provisions regulating:

- Managed investment Schemes;
- Australian Financial Services Licensing;
- Anti-hawking; and
- Product disclosure.

The majority of farming businesses across Australia are family owned and operated; with business principals indistinguishable from the family retail investors who obtain the benefit of the regulatory framework that covers other management investment schemes. On this basis, GPA does not believe that the regulatory framework for managed investment schemes marketing primary produce should differ from the institutional settings developed to protect the interests of retail investors.

Therefore, ***GPA does not support the proposal contained within the consultation paper to remake CO 02/211*** as it would sustain the current failure to provide regulatory oversight for the management of grain pools.

If ASIC maintains its current inclination to remake CO 02/211, GPA recommends that this should be only done after undertaking further regulatory analysis that examines the costs borne by farmers in the absence of appropriate regulation of grain pools as financial instruments. The recommended regulatory analysis should examine the following scenarios:

- No exemption of grain pool products from regulation under the *Corporations Act 2001*, whether by allowing CO 02/211 to sunset without replacement, or alternatively by excising grain pool products from any subsequent remade order.
- Remaking CO 02/211 with specific provisions that must be followed by operators of grain pools in order to meet the requirements of the

exemption. This could be done by mandating industry codes of practice in a similar fashion to syndication of horse breeding schemes by Class Orders 02/172 and 02/178 respectively.

- Remaking the exemption on its current terms.

Grain Pool Products

The use of grain marketing pools has historically provided farmers with a useful marketing tool to manage price variation. While the reliance on grain pools has diminished in the period subsequent to the dismantling of the previous single desk export wheat marketing arrangements, their utility remains as an important risk management tool for farmers. This is particularly so in periods where the global price for wheat is low, such as in the present period.

Grain pools are managed investment schemes, in which farmers commit grain into a "pool" in exchange for an interest in the marketing pool. The marketing pool is then managed by a professional pool operator, normally an experienced grain trading organisation.

Under these arrangements the contributions that the pool provider receives from contributors (interest holders) are pooled to produce financial benefits for the contributors (interest holders). The financial benefits arise through better marketing or lower cost of marketing or more favourable terms of payment for marketed grain. The pool provider charges contributors (interest holders) a management fee in addition to the cost of establishing and running the pool. These fees and costs are extracted from the pool return.

This is similar to other managed investment schemes where retail investors pool funds, which are then managed by a professional funds manager for their benefit.

Market Failure

As the performance of a pool cannot be known well before the decision to enter the pool is made, there is an incentive for the pool operator to claim that a pool is good regardless of its true nature.

In the iconic 1970 paper *'The Market for "Lemons": Quality, Uncertainty and the Market Mechanism',* George Akerlof, establishes a structure for determining the economic costs of dishonesty and proposes the major cost of dishonesty which is – *'dishonest dealings tend to drive honest dealings out of the market*'. This occurs as rational farmers, aware of information asymmetry and the arising perverse incentives, act on the belief that only underperforming pools are available on the market and the market will tend towards a market where only underperforming pools are offered and entered into by increasingly sceptical farmers.

When we apply George Akerlof's insights regarding asymmetrical information within the context of grain pools the obvious extension is the principal-agent dilemma. This dilemma emerges when a principal employs an agent in an environment with incomplete or asymmetrical information. At its core the challenge is to ensure an agent acts for the principal at the same level of diligence with which the principal would act for itself if it had the same skills as those acquired by the agent. The principal in the case of grain marketing pools is the farmer who supplies the grain to the pool and the agent is the pool provider.

Deviations from this level of diligence occurs when potential benefits may be gained by the agent at the expense of the principal or where it is not possible for the principal to observe and monitor and ultimately influence the performance of the agent.

The application of Akerlof's observations may be seen in the concentration of incidences where the Final Pool Return (FPR) has been lower than the Estimated Pool Return (EPR). In the analysis period 2009/10 - 2010/112 PwC reported that 75% of pools had a lower FPR than average EPR quoted during the decision period and only 43% of FPRs were within $10 per tonne of the average EPR during the decision period.[1]

This evidence indicates that during the period of analysis there was a consistent failure by the majority of pool providers to advertise EPRs in line with a more realistic expectation of the likely pool performance. GPA does not seek to make a value statement regarding whether this is due to a lack of competence of pool managers, or a deliberate effort to exploit farmers by inducing them to commit grain to the pool by advertising prices higher than the likely returns. However, regardless of the underlying cause, it has a detrimental impact on the ability of the farming business to budget and adverse implications for the ability of the business to invest in growing its on-farm productivity.

GPA is of the belief that a lack of regulatory oversight afforded to grain pools under Class Order 02/211 leads to concerns, both real and perceived, about whether operators of pools have the necessary competence to adequately manage grain pools; and whether they are acting in the best interests of those grain farmers with equity in the pool. Grain farmers have raised concerns of inappropriate self-dealing, specifically over how pool providers have failed to manage cash trading operations at arm's length to the management of the marketing pools it operates. These concerns have specifically included whether

[1] See The PwC report *Analysis for Growers. Estimated Pool Returns: the Relationship to Final Price.* 17 August 2012. The Decision Period is defined as the time a farmer had available to make the decision to enter into the pool. An update to the report that included the 2011/12 period indicated estimated pool returns were on average $9 higher than final pool returns over the three year period.

pool providers have maintained a separation of pool property against that of cash trading operations.

Along this vein, rural media has recently reported a class action by farmers against a pool manager. The report alleges the pool underperformed the market by as much as $74 per tonne with total losses of $7.4 million being claimed.[2]

The asymmetry of information in grain markets, as for financial products, is an endemic issue and ultimately some degree of market failure will occur requiring the adequate design and enforcement of public policy to ensure the effects of this market failure is at least minimised.

Product Disclosure and compliance

In response to a consultation paper that was released in April 2010 by the Australian Securities and Investment Commission further disclosure requirements were imposed on Agribusiness managed investment schemes.[3] These types of schemes are not exempt from the regulatory framework of the Corporation Act 2001 like grain marketing pools.

The regulatory framework under the Corporations Act 2001 is intended to provide adequate disclosure about financial products, including offers of interests in agribusiness schemes. ASIC was concerned that the disclosure practices of the time were not resulting in documents that clearly and adequately discussed the risks associated with investing in agribusiness schemes in accordance with the law resulting in retailer investors investing in schemes without an adequate understanding of the risks.

In this case ASIC responded that in general the Product Disclosure Statements did not always meet ASIC's expectations of a 'clear, concise and effective' document as required by the regulatory framework. ASIC noted that agribusiness schemes are often specific in their nature and that Product Disclosure Statements are likely to be the main source of information that investors receive with a degree of independence.[4] In this particular instance ASIC believed that the benefits of clearer information disclosure which outlined the risks associated with the schemes and the whether the responsible entity has, where possible, strategies in place to mitigate these risks, outweighed the identified compliance costs.[5] In its assessment of benefits, ASIC recognised the

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[2] Gregor Heard, "Emerald taken to Court", *The Land* (1 September 2016).

[3] See Consultation Paper 133 Agribusiness managed investment schemes: improving disclosure for retail investors (CP133)

[4] Australian Securities and Investment Commission, 2012, Regultion Impact Statement – Agribusiness managed investment schemes: Improving disclosure for retail investors.

[5] See Regulation Impact Statement - Agribusiness managed investment schemes: Improving disclosure for retail investors

impact current practices were having on long term investment in the agricultural industry.

GPA recognises that agribusiness managed investment schemes are not perfectly akin to grain marketing pools which are a special kind of managed investment scheme.[6] However, while previous experiences with agribusiness managed investment schemes are not definitive, they remain indicative.

In further considering the need for mandated product disclosure and appropriate compliance and auditing requirements, it is worth highlighting that similar to other managed investment schemes, pool providers implement different strategies to provide returns to the pool. These strategies contain the costs of implementation and risks to the estimated return from the implementation of the strategy.

Firstly, without understanding these risks and costs, grain farmers are unable to accurately assess the commercial risk to their farming business of committing grain to the pool. Similarly, where it becomes apparent that a change to an estimated return is required, this needs to be communicated rapidly to growers who have committed grain to the pool to assist them with the management of both business and personal finances.

Secondly, without regulated compliance requirements, GPA holds concerns over the lack of effective deterrence to follow the disclosed strategy. GPA members have reported it is not uncommon for pool providers to increase their estimated pool return during the harvest period as a form of competition against other pool providers in an effort to capture volume into the pool. Likewise, compliance against the marketing strategy of a pool is important to ensuring that growers who have committed grain to a pool are not subject to risks they were not informed of prior to entering the pool.

Costs of not regulating grain pools

When examining the benefits of further regulation, GPA would like to reiterate the point of George Akerlof who noted that 'the cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost must also include the loss incurred from driving legitimate business out of existence'[7]. The

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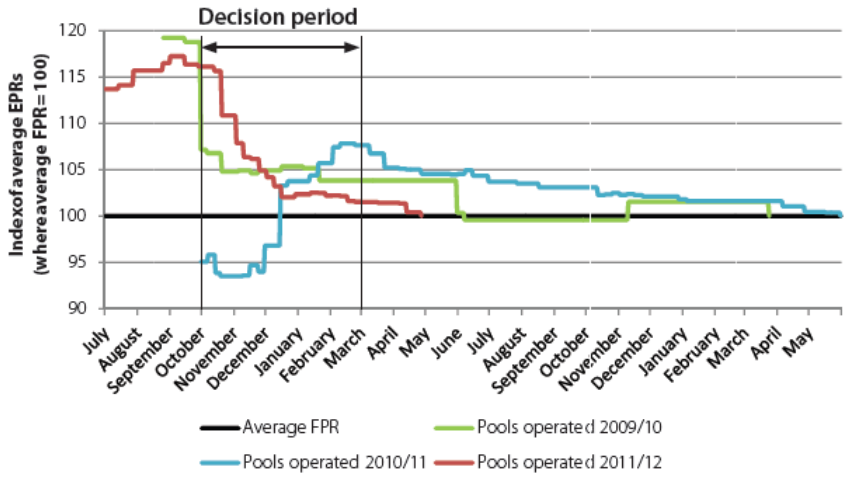
[6] Agribusiness managed investment schemes have both production and market risks arising from varying costs of production and yield. Grain marketing pools as a special example of managed investment schemes do not have the same production risks as agribusiness schemes. This is because harvested grain is a readily movable inventory or liquid asset, post production risk (ignoring operating, storage and logistics costs which could be viewed as a production cost susceptible to risk).

[7] Akerlof, G. A. 1970. The Market for "Lemons": Quality Uncertainty and the Market Mechanism, *The Quarterly Journal of Economics,* Vol. 84, No. 3.MIT Press, p. 488-500.

cost here is not only the loss to individual farmers but the long term loss incurred from legitimate pools being forced out of existence.

As previously reported there have been a significant number of incidences where the Final Pool Return (FPR) was lower than the Estimated Pool Return (EPR). This is indicated in the figure reproduced below.[8]

Figure 2: *Average EPRs and average FPRs for the 2009/10, 2010/11 and 2011/12* pools (difference is presented as an index where average FPR = 100).*



Combined with speculation over well profiled poor pool results, aversion among grain producers over the use of pool products has increased.[9]

Wheat Industry Advisory Taskforce

In response to industry concerns over the lack of regulatory oversight for grain pools, the Commonwealth Government convened the Wheat Industry Advisory Taskforce (WIAT) in 2013. One of the aspects of the grains industry the WIAT examined was the regulation of grain pools. While the WIAT recommended the maintenance of the exemption, based on the likely burden of increased compliance costs, it recognised that this recommendation bucked the norms of consumer protection for managed investment schemes. In doing so, the taskforce recognised the benefits of removing the exemptions, including:

- A product disclosure statement would be required to be produced prior to a farmer electing to contract or deliver into a pool

[8] Above n.1.

[9] See above n.2; see also WA Country Hour, Friday 28 June 2013, ABC Rural. Available here: http://www.abc.net.au/news/2013-06-28/emerald-grain-pool-class-action-millions-dollars-lost/4787012

- Ring-fencing of assets and separate financial reporting on a regular basis is published to pool participants and available for ASIC to review as necessary
- A requirement for a constitution and appropriate independent governance, at arm's-length to other proprietary commodity trading activities of a pool provider, and documentation of decisions
- Regular reporting of performance
- A recognised and effective dispute resolution mechanism is mandatory
- Breaches are dealt with by an independent regulator under the *Corporations Act 2001*.

Whilst GPA recognises the concerns raised regarding the financial returns within the report, our overriding concern is ensuring appropriate consumer protection is provided to grain producers when contributing to grain pools. GPA additionally believes that without this regulatory oversight, the lack of confidence in pools will see an under-utilisation of them as a risk management tool.

GPA does not support a continuation of the exemptions

Based on the arguments outlined above, GPA does not support the continuation of the exemption, at least for grain pools. Rather, our members believe more appropriate oversight of pools will result in greater confidence in pool products by farmers, leading to greater innovation and competition between pool providers.

Specifically, GPA believes the requirement for Australian Financial Service Licencing, combined with requirements of scheme design, governance and compliance, are necessary to manage the principle and agency problems created by the conflicts of interest held by the pool operator.[10]

Likewise, mandating the provision of product disclosure statements will provide information to grain producers to enable them to make decisions over the strategy of the pool management and estimated returns, based on an understood duty in the preparation of Product Disclosure Statements (PDS). This will include the existing requirement for PDSs to be updated as material changes occur to the market or the management strategy.

Further regulatory analysis is required

[10] See Robert Bianchi, "Principal and agent problems in Australian responsible entities", *Deakin Business Review*, v 3(1), 23-30.

Without detracting from our clear position of not supporting a continuation of the exemptions as outlined above, GPA believes further regulatory analysis is required.

There must be rigor in the process followed by ASIC prior to determining its response to the expiration of CO 02/211. When researching to make submissions to the WIAT review of grain pools as financial products, GPA member NSW Farmers sought access to materials developed as part of a regulatory analysis for the creation of the existing class order; however, such materials were not readily accessible upon request. This means that there are no materials readily available for Government or industry to consider whether the sunset or remake of the exemption, on existing or new terms, is the desirable regulatory option. Additionally, GPA is unaware as to whether the original exemption actively considered impacts on the grain market.

Even if a RIS was undertaken at that time, given the changes in the grain market place since that period of time, GPA believes that it would be appropriate for any analysis to be brought up to date.

Therefore **if ASIC maintains its current inclination to remake CO 02/211, GPA recommends this should be only done after undertaking further regulatory analysis that examines the costs borne by farmers** in the absence of appropriate regulation of grain pools as financial instruments. Further, costs assessed should include the cost of less than optimal use of pools by grain producers as a tool to manage marketing risk.

If as part of this regulatory analysis, the costs of allowing the exemption to sunset was considered excessive against the benefit it offers to grain producers, GPA recommends ASIC also analyse the third option of a co-regulatory approach. Under this scenario, GPA propose that compliance with the GTA Code of Practice's requirements for pool providers should be incorporated as a condition of the exemption. GPA understands that a similar provision had been incorporated into exemptions from the managed investment scheme requirements for the syndication of horse breeding schemes.[11] Additionally, ASIC should consider the appropriateness of the GTA code to the specific risks of grain pool products and provide advice to GTA and the broader industry of these findings.

[11] Class Orders 02/172 and 02/178.

Conclusion

GPA does not support a continuation of the exemption, believing that it would be preferable for ASIC to allow the class exemption to sunset due to the effect it has in excluding providers of grain marketing pools from appropriate financial regulation .

If ASIC maintains its current inclination to remake CO 02/211, GPA recommends this should be only done after undertaking further regulatory analysis

This recommended regulatory analysis should carefully examine the following scenarios:

- No exemption of grain pool products from regulation under the *Corporations Act 2001*, whether by allowing CO 02/211 to sunset without replacement, or alternatively by exercising grain pool products from any subsequent remade order.
- Remaking CO 02/211 with specific provisions that must be followed by operators of grain pools in order to meet the requirements of the exemption. This could be done by mandating industry codes of practice in a similar fashion to syndication of horse breeding schemes by Class Orders 02/172 and 02/178 respectively.
- Remaking the exemption on its current terms.

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