Chapter 7 The responsible entity and others involved in the operation of a scheme

Template for submissions

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7.1 Duty to treat members equally

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'?
Submission No, except in relation to the distinction between wholesale and retail clients.
Question 7.1.2 Are there any reasons why such a change should not be made?
Submission "Equally" is unequivocal. "Fairly" is open to abuse and could lead to all kinds of inequities between members. There are, however, good grounds for distinctions between wholesale investors and retail investors. Wholesale investors are usually careful in conducting due diligence and ongoing monitoring, and the presence of wholesale investors in a managed investment scheme assists retail investors who are

usually more passive and have fewer resources.

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)?

Submission

Yes, disclosure.

7.2 RE's entitlement to fees and indemnities

Question 7.2.1
What issues have arisen in practice in relation to the concept of 'proper performance' of an RE's duties?

Submission

There is a question as to whether or not fees in agricultural schemes are payable "out of scheme property", as if they were paid from a trust fund. The question depends upon whether they are "contributions to the scheme", like contributions to a trust fund. There is a possibility that fees may be payable otherwise than out of scheme property by reason of a separate agreement between the RE and the scheme member (see Jessup: Managed Investment Schemes para 7.6 and *Alpha Wealth Financial Services Pty Ltd v Frankland River Olive Company Ltd* [2008] WASCA 119).

Primary Securities has always treated fees as contributions "to the scheme" but to the extent that they are, their status as such vanishes as soon as they are received. If fees are simply received as fees, then they probably do not constitute contributions "to the scheme". If they are not contributions "to the scheme" but simply fees to the RE, then section 601GA(2)(b) does not apply at all. There is a legislative gap. Such fees then do not have to be spent for the proper performance of the duties of the RE.

If section 601GA(2)(b) does apply to fees in agricultural schemes, then there is a question as to whether or not that section is merely a requirement as to what must be included in a Constitution, or is also proscriptive of how fees must be treated. Primary Securities has always regarded the section as proscriptive and has placed fees in separate fee account to be used "for the proper performance" of the

RE's duties.

This means (in Primary's view) that the fees must be applied gradually over the course of the period for which the duties are to be carried out. In other words, it is not permissible to take the fees and put them in globo into the RE's general account whereby ordinary creditors of the RE can seize them.

This has occurred in a number of windings up of forestry schemes, including one example where the scheme members made contributions to plant trees on 30 June and the responsible entity was put into receivership the next day, on 1 July. The receivers (bank) took all fees paid on 30 June but no services were carried out. In that case, tens of thousands of seedlings were never planted and died.

If fees are paid in advance, the legislation should make it clear that the fees must first be put into a fee account whereupon they are subject to an obligation to be applied as required under the statutory duty in section 601GA(2)(b). The fees are then gradually paid to the general account as the work is done.

Question 7.2.2
If clarification of the meaning of 'proper performance' is required, which of the options mentioned in Section 7.2 should be adopted? Alternatively, should some other option be adopted and, if so, what?

Submission

Options 1 and 3 are quite inappropriate. Suppose a fee is payable in advance for work to be carried out over the life of a scheme – 25 years. It would be wrong not to permit the fee to be paid for 25 years. How is 25 years of work to be carried out without accessing the fees paid for that work? There should be no link between fees and breach. Breach is a separate matter. Option 2 is the correct interpretation.

The fees should be paid if there is proper performance of the duties. The fees should be payable ONLY if there is performance. Non-performance means the fees stop being paid. Non-performance may or may not be a breach, there may be a good reason for non-performance unrelated to breach.

The provisions should be interpreted to mean that for work for which the fee is done, that work actually has to be carried out, and the fee is only earned as the work is carried out. The fee should be able to be gradually paid from the fee account to the RE's general account as the work is done, and to pay for that work, in the same way as fees paid in advance are treated under the *Arthur Murray* principle – they are not "earned" until the services are carried out. It is inappropriate to interpret section 601GA(2)(b) as limiting the RE to any fees unless and until it has carried out all duties required of it without breach.

If there has been a breach of obligations of the RE, this is something that needs to be separately considered, outside the matter of fees.

Question 7.2.3
If Option 3 or Option 4 in Section 7.2 is adopted, should any restored entitlement to fees or rights of indemnity or reimbursement extend to amounts relating to the period of the breach?

Submission

As to Option 4, we cannot see this working in practice. Is CAMAC expecting an RE to be so disinterested as to recognise a breach, calculate the appropriate loss to scheme members, reimburse them for that loss and carry on as if all was normal? This is in our view unreal. We can hardly see this operating with success.

What kinds of breach are contemplated by CAMAC? Failure to insure? Investing too much into one high risk investment? Lending without security resulting in total loss? Failing to properly explain the risks of the scheme? Failing to register an instrument on the title? Failing to plant trees during the wet season so that the trees all die? (all actual examples we have come across).

Does CAMAC contemplate that the RE is simply able to remedy a breach by some credit against its fees? Each of the breach examples given in the last paragraph would be substantial breaches significantly outweighing any fees that might be payable to the RE.

Fees are liquidated claims and damages for breach are unliquidated claims.

Suppose an RE is covered by professional indemnity for a breach. Is the RE expected to make a claim on its PI policy on behalf of investors on account of its own negligence? Surely such an act would invalidate the policy as the RE is under an obligation to act as a prudential insured and deny any claim, or require it to be properly proved.

The only solution for breaches that are significant is for the scheme members to change RE.

Perhaps there needs to be some procedure to alert scheme members when there has been a breach for which damages are payable. The scheme members can then decide whether or not to try and change the RE.

Question 7.2.4
If Option 5 in Section 7.2 is adopted, what standard for determining ‘proper performance’ should be specified?

Submission

Option 5 should not be adopted.

7.3 Attribution to the responsible entity of acts or omissions of persons engaged to perform the responsible entity's functions

Question 7.3.1 For what purposes, or in what circumstances, should an RE be liable for the acts and omissions of its agents?
Submission In all cases. We see no reason for change.
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?
Submission Primary accepts that liability.
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?
Submission Double compensation should not be possible as recompense by one party would be set off against any compensation awarded against another.

7.4 Disclosure of interests of directors of the responsible entity

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?
Submission Yes, except that the disclosure should also extend to directors of a management company engaged by the RE to manage the scheme.

7.5 Related party transactions

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?
Submission Yes. To continue to ensure that it covers agents and persons engaged by the RE to manage the scheme. This is necessary because many REs are merely AFSL lenders for the actual operator of the scheme.
Question 7.5.2 Should the RE be subject to criminal liability and/or civil penalties for breach of the related party provisions?
Submission As currently provided.

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?

Submission

As currently provided.

7.6 Change of responsible entity

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?

Submission

Yes, in the following circumstances:

- Where the new RE is a member of the same corporate group as the previous RE unless within a month of being advised of the right to do so, at least 5% of scheme members require a meeting to approve the appointment (as is currently the case where ASIC sometimes gives relief)
- Where the incumbent RE has retired and appointed a replacement RE unless within a month of being advised of the right to do so, at least 5% of scheme members require a meeting to approve the appointment
- Where the incumbent RE is under external control and a new RE has been appointed by the court, unless within a month of being advised of the right to do so, at least 5% of scheme members require a meeting to approve the appointment
- Where the incumbent RE is otherwise non-compliant (insolvent, insufficient NTA or cash, no appropriate responsible officer etc), and a new RE has been appointed by the court unless within a month of being advised of the right to do so, at least 5% of scheme members require a meeting to approve the appointment
- Where the incumbent RE has a serious conflict of interest and a new RE has been appointed by the court unless within a month of being advised of the right to do so, at least 5% of

scheme members require a meeting to approve the appointment.

7.7 Scheme custodians

Question 7.7.1 Should custodians of scheme property be required to hold an Australian financial services licence?
Submission No. Primary Securities sees no reason for any change.
Question 7.7.2 Are there any reasons why scheme custodians should not be required to be licensed?
Submission 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?
Submission No.

Question 7.7.4
Should the Corporations Act be amended to allow for a custodian to operate a designated account for holding application money?

Submission

No. This would be really inconvenient when raising money. It is quite important for the RE to have a good understanding of what has been received on a day to day basis, and from whom, or from what sources.

Other comments

Please insert any other comments you may have on the matters covered in this chapter.

Submission

Difference between managed investment schemes and companies

There is a general theme throughout the Discussion Paper that the rules for companies and managed investment schemes should be brought more into line. We have sympathy for this but there are important differences between companies and managed investment schemes.

Board members of companies most often have a substantial stake in the company. Hence, the assets of the company are in part their own assets and any loss is a loss to themselves. The board of a company is able to use the assets of the company as it wishes, and has discretion in relation to remuneration and board fees. A company is a vehicle designed for risk taking and members have limited liability. Boards of a company rarely appoint a management company to run their activities, and self-manage.

Managed investment schemes are mostly trusts and the controlling responsible entities often have no or very few units in the trust and are simply managers of the assets of the trust. The responsible entity of a managed investment scheme is only able to use the scheme assets as authorised under the Constitution and can only pay such fees as are strictly authorised. A trust is not a vehicle designed for risk taking and members do not have limited liability. The RE is merely a manager. Frequently, the RE appoints a management company to operate the scheme, so the RE is even more removed, overseeing another manager.

Replacing the RE

Strangely, when REs are simply managers of other peoples' assets, they are immune from takeover.

The current legislative regime prevents or discourages takeovers and enables poor responsible entities to stay in place, or even makes it impossible to replace them.

This has led to abuse with entrenched REs plundering the assets they manage or being lazy. Managed investment schemes are rife with examples of poor management, exploitation, negligence, conflict and even fraud.

It is not only poor managers who need to be replaced, any responsible entity needs to be constantly under pressure to reduce their fees because of the possibility of being replaced by a lower fee RE. What of the situation where a potential new RE promises to lower fees by 0.25% per annum? It is in the public interest that the rules encourage such takeovers.

Scheme members should be able to readily and easily replace a responsible entity as all they are doing is replacing the manager of their assets. Why should a mere manager possibly with no stake in a scheme have any special privileges?

In other words, rather than bringing companies and managed investment schemes into line in relation to changing the responsible entity and takeovers, the ability to change responsible entity should be made **easier** than it is to change the board of a company.

Facilitating changes in the responsible entity

Primary Securities proposes the following changes to the current regime to make it easier for scheme members to change responsible entity of a registered scheme:

- Regulation 2C.1.03(e) currently prohibits the use of a register for the purpose of making an offer to purchase a financial product that satisfies paragraphs 1019D(1)(a) to (d) of the Corporations Act. This regulation renders every responsible entity of an unlisted scheme absolutely immune from takeover as no-one is able to obtain a copy of the register with a view to purchasing units or shares. The effect of this regulation is to leave unit holders and shareholders who are being oppressed or exploited utterly without an important remedy, namely to start to buy up units with a view to taking over the trust or company, or to replacing the RE. Primary Securities understands the historic reasons for this rule, but an absolute prohibition is going too far. There is adequate protection imposed by virtue of section 1019D on its own without completely prohibiting the use of the register for takeovers.
- When an investor register is provided to a party contemplating a takeover, invariably the register omits email addresses and telephone numbers. The RE trying to replace the incumbent RE has to mail everything, while the incumbent RE can cost effectively and quickly email and even phone investors (mostly to misinform scheme members about the proposed new RE or the virtues of the incumbent RE). The incumbent RE should be required to provide email addresses and telephone numbers (at least in relation to possible attempts to replace the incumbent RE).
- The current voting requirements for takeover of unlisted schemes are very onerous. The requirement is for an “extraordinary resolution” which is a resolution “that has been passed by at least 50% of the total votes that may be cast by members entitled to vote (including members who are not present in person or by proxy).” Primary Securities can give the example of the Templegate schemes which were pine schemes which had been in existence since 1988. In 2010, the receivers and managers of Great Southern were proposing to terminate these schemes only a year or so after Great Southern had received substantial offers for the trees following a tender process. In other words, the receivers and managers who controlled the RE simply wanted to terminate the schemes so that the banks could take the land and trees on an unencumbered basis. Primary Securities arranged for 5% of scheme members to convene a meeting to change the RE. However, getting the required number of votes to change the responsible entity to Primary Securities Ltd was very difficult as many of the investors were dead or deregistered or their addresses unknown. Nonetheless, the required vote was obtained, but only through the mammoth effort of some of the scheme members. This is an example of where investors simply had to vote or lose everything. And it was still difficult and time consuming to bring in the required proxies to reach 50% of all

interests. Several reports have recommended that these onerous rules be changed and it is time this happened. No-one is protected except the incumbent RE.

- The problem for a prospective new RE is that obligations and liabilities may have been entered into in relation to a scheme which are unexpected or unknown and a new RE could be surprised upon takeover to find those obligations exist. As takeovers are usually hostile, the incumbent RE is not going to volunteer information to a prospective RE as this may assist the prospective RE in understanding or reducing the risks of takeover. There should be a requirement that upon 5% of scheme members calling a meeting to replace an incumbent RE, the incumbent RE should be obliged to make available to the unit holders calling the meeting (for the benefit of the prospective RE) such information as the prospective RE reasonably requires.
- Any management agreements entered into by the incumbent RE should cease to be binding from the date of change of an RE, otherwise the new RE could take over to find that a subsidiary of the previous RE is still operating the scheme.
- Any agreements of benefit to the incumbent RE (for example forestry rights on the title to protect the interest of scheme members) should not terminate on change of RE (as is the case with some of the Willmott Forests agreements).
- ASIC currently requires a new RE to continue to use the previous RE's auditors to until completion of the next audit, even after takeover. Following takeover, in the interest of scheme members, the new RE should be encouraged to inquire into the conduct of the past responsible entity and its auditors (particularly after an insolvency). A new RE should be able to immediately replace the auditors should it wish to do so without having to commence proceedings in the Administrative Appeals Tribunal (as Primary Securities was once forced to do) to effect a change of auditors, after replacing another RE.
- Following takeover, a new RE should not be penalised for the failures of the previous RE. For example, when Primary Securities has taken over schemes from insolvent REs we always have to prepare and file financial statements late (in one case, 8 years of financial statements had to be prepared and filed). Each time, Primary Securities is asked to pay penalties which are sometimes (but not always) able to be passed on to the scheme. This is inappropriate. Also, we have sometimes been asked by ASIC to prepare half yearly financial statements in such circumstances, which we refuse to do when they are being lodged years later, simply because this is pointless.