12. No compulsory third party needed

Introduction

12.1 All collective investment schemes must have at least a scheme operator and investors. The new regulatory regime recommended by the Review will impose on the operator directly a number of clear, inescapable duties, including compliance with the law and the scheme's constitution. It will also require that operators be licensed by the ASC. This chapter discusses whether, in the light of these recommendations, there is also a need for a compulsory third party, such as a trustee, for all schemes under the new regime. It sets out the present law and its shortcomings and the alternative ways in which reform can be approached. The Review has concluded that there is no need for a compulsory third party under the new regime.

The present law

12.2 Under the present law, prescribed interest schemes must have both a manager and trustee or investors' representative.[1] The manager establishes and promotes the scheme. It also selects the trustee or representative. The trustee holds the property of the scheme,[2] supervises the manager[3] and acts as the representative of investors. The manager must hold a securities dealers licence[4] and the trustee must be approved by the ASC.[5] Interests in a scheme may not be issued unless the deed constituting the scheme has been approved by the ASC.

Shortcomings of the present law

Present structure unsatisfactory

12.3 ***Introduction.*** The current mandatory trustee and management company arrangement for prescribed interests is unsatisfactory. The rules governing the distribution of powers and responsibilities between the two parties have developed in an ad hoc fashion. In theory, the system should achieve the policy goals the Review has set out for the regulation of collective investment schemes. In particular, it should afford investors appropriate protection. Unfortunately, in practice, the scheme has failed to prevent some significant instances of non-

1. Unless an exemption is granted, as in the case of trustee common funds: see ASC Policy Statement 32. The 'two party' structure for prescribed interests contrasts with the legal regime for public companies which are not required to have a trustee or representative of shareholders.
2. Unless the investors hold the legal title themselves.
3. The extent of the trustee's legal obligation to supervise the manager is not clear. It appears that the ASC, trustees and managers have different views on the issue.
4. Because the ASC takes the view that issuing units in a prescribed interest scheme constitutes carrying on a business of dealing in securities.
5. Corporations Law s 1065, 1066. The Review notes that the ASC is currently reviewing its approval process for trustees.

compliance with the law. It appears to offer additional security for investors because it involves a trustee that is independent of the management company supervising the actions of that company on their behalf. This additional security, however, is at times illusory. The system contains fundamental legal and commercial contradictions.

12.4 ***Legal confusion and uncertainty.*** The traditional role of a trustee was to undertake full responsibility for the operation of the trust. In time, some trustees engaged other persons with relevant expertise to perform some functions on their behalf. Superannuation schemes are an example. In many large superannuation schemes, a professional fund manager is engaged by the trustee to make the asset selections, subject to the trustee's approval. The manager is dependant on the trustee for its appointment and is accountable to it. The trustee remains fully accountable to the beneficiaries of the trust for all aspects of the trust's operations. In unit trusts responsibility to the beneficiaries is split between the management company and the trustee. The law, however, has not taken account of these new arrangements. It still assumes that the relationship between trustee and manager, in which the manager is engaged by the trustee, persists. For example, one of the key statutory obligations of a trustee is to exercise

> all due diligence and vigilance in carrying out . . . its functions and duties and in protecting the rights and interests of [investors].[6]

The security and commercial benefit this obligation provides for investors is unclear. Trustees themselves are quite equivocal on what, if any, powers or responsibilities this obligation imposes on them. One leading trustee company stated that

> it is inappropriate for the trustee to be involved in determining the commercial wisdom of each of the manager's investment decisions.[7]

Nevertheless, it considered that a trustee should be able to reject an investment proposal on the ground that it is 'manifestly not in the interests of investors'. In this it was supported by another leading trustee company.[8] The dual responsibility structure has led to confusion about what protection is afforded to investors and may well be misleading as it does not emphasise that the management company not only has responsibility for the management of the commercial aspects of the scheme but for ensuring that its activities comply with the law and the scheme's deed.The very fact of split responsibility is a problem.

12.5 ***Inadequate fee structure.*** There is serious doubt whether the existing fee structure for trustees enables them to carry out their statutory functions satisfactorily. The fees charged by trustees of prescribed interest schemes are generally determined as a small percentage (often no more than 0.1%) of the value

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6. Corporations Law s 1069(1)(e)(i).
7. Perpetual Trustees Australia Limited *Submission* 10 December 1992.
8. Permanent Trustee Company Limited *Submission* 12 November 1992. Both submissions took the view that trustees should not be liable for acting on that opinion, or for failure to form such an opinion or act on it, unless there was a lack of good faith on their part. As a result trustee companies would acquire power without responsibility.

of the scheme assets, regardless of the workload. There is a widespread view among industry participants that this fee structure does not provide enough revenue for trustee companies to carry out their statutory obligations effectively.[9] The trustee companies themselves acknowledge this as a problem.

> We believe that fees have been negotiated on the basis of a certain understanding of what the role will require. Subsequently, this role has changed because of increased responsibilities without a corresponding increase in remuneration. Under existing deeds the only way that an increase in fees can occur is by investors' approval. Realistically it must be recognised that, notwithstanding any commercial justification for the increase, unit holders are unlikely to approve the increase if it means a reduction in their return.[10]

Two approaches

Introduction

12.6 Reform is clearly needed. Virtually all submissions agreed. The Review considered two possible approaches:

- revise the role and functions of trustees and management companies, within the present regime of split responsibilities, by identifying more precisely their respective powers, duties and liabilities
- focus instead on the role of a single scheme operator and appropriate compliance measures and, after that, ask whether a compulsory third party is still necessary.

Refining the current system

12.7 Some submissions, while acknowledging problems in the existing arrangement, argued that it should be improved and refined rather than replaced. The main measures suggested involved clarifying the respective roles of the management company and the trustee, either by amending existing mandatory covenants or by introducing statements setting out each party's role more clearly.[11] Any such reworking will not overcome the inherent problems of divided powers and responsibilities in a dual system, and the inevitable legal complexity and uncertainty that this creates. One submission to IP 10 pointed out

> [i]f managers are made primarily liable to unit holders and required to undertake fiduciary obligations as opposed to merely contractual ones, it is submitted that they should be more circumspect in making decisions. Managers are often prone to take a

9. eg IFA *Submission* 1 December 1992.
10. Perpetual Trustees Australia Limited *Submission* 1 December 1992.
11. See, eg, Permanent Trustee Company Limited *Submission* 12 November 1992; Perpetual Trustees Australia Limited *Submission* 1 December 1992; TCA Submission 10 December 1992; National Mutual *Submission* 3 December 1992; Wessex Fund Management Limited *Submission* 26 November 1992. Permanent Trustee Company Limited suggested that the roles of the managers and the trustee may not always be fully appreciated by lawyers, the courts and the regulators, as well as the investors: *Submission* 12 November 1992.

> robust view on matters relating to interpretation of the trust deed and action authorised under it. If required to act as a trustee, they should be more likely to act with a prudent regard for the terms of the deed.[12]

There is a further concern. Use of trust terminology may create the false impression that common law trust principles apply in full. Trustees of prescribed interest schemes, unlike traditional trustees, do not bear ultimate responsibility. Likewise, to the extent that trustees rely on management companies for their appointment, they may be compromised in their 'supervisory' role, whatever their powers and responsibilities in law.[13] The Review accepts that statutory trustee companies fully appreciate their responsibilities. Nevertheless, the interests of investors may be substantially prejudiced by any of these consequences. A refined system will not create a better, or even necessarily an acceptable, compliance system.

A fresh approach preferred

12.8 ***Introduction.*** The Review proposes a new regime, a fresh approach to the regulation of collective investment schemes. A new approach is needed to support the policies and principles that should underlie the regulation of these schemes. Under this new regime, it is simply unnecessary to require a third party. The new regime places full responsibility for the operation of a scheme on one scheme operator.

12.9 ***Legal clarification and simplification.*** The new regime imposes clear and non-delegable legal obligations on scheme operators and their directors with criminal and civil liability for breach. It also makes compliance with the law and the scheme's constitution the focal point of regulation. A scheme operator may contract out certain functions, but this private arrangement has no bearing on the operator's ultimate liability in law for the exercise of these functions.

12.10 ***Commercial flexibility.*** A significant benefit that flows from this approach is that it encourages flexibility and the adoption of the most appropriate structure for each scheme. It permits an external party to be involved in compliance where this is appropriate, without creating a duplication of functions and additional costs where scheme operators themselves have adequate and cost-effective measures to check compliance with the law and the scheme constitution.

12.11 ***Consistency with other corporate structures.*** The remedies available against scheme operators would be similar to those against other corporations, including investment companies. The single operator arrangement also applies to common funds administered by trustee companies. One submission to IP 10 pointed out that

> if fiduciary obligations are imposed upon managers, and beneficiaries have conferred on them other rights similar to those of shareholders in companies, then the basis of the existence of separate trustees falls away. Other non-prescribed interest forms of investment, such as shares in a company, do not have 'trustees' appointed to watch

12. Law Council of Australia *Submission* 21 February 1992.
13. The Review understands that some trustee companies derive more than 50% of their total income from unit trust administration.

> over the rights, say, of the shareholders. Perhaps the difference lies in the fact that the directors of a company are directly responsible to the company for their decisions and owe fiduciary duties to the company in the exercise of their powers and duties. When a person is under fiduciary duties of his own, it should not be necessary for another fiduciary to watch that those fiduciary duties are performed.[14]

A compulsory third party is unnecessary

12.12 In the new regime, a compulsory third party is unnecessary.[15] Trustees may continue to be involved in collective investment schemes, as scheme operators, for example, of their common funds, or as parties engaged to undertake an external compliance role for a particular scheme. There will always be a single operator responsible for all aspects of the scheme's compliance with the law and its constitution. No other party is required. Accordingly, the Review **recommends** that the Corporations Law should not require the operator of a collective investment scheme to involve another entity in the operation of the scheme.

14. Law Council of Australia *Submission* 21 February 1992.
15. The Treasurer has indicated that the regulation of pooled superannuation trusts (PSTs) will be changed so that the trustee will be wholly responsible to the unitholders for the management of the PST and there will be no requirement for the manager and the trustee of a PST to be separate persons: J Dawkins, Treasurer *Strengthening Super Security: New Prudential arrangements for Superannuation* AGPS Canberra 1992.