2. Policies and principles

Introduction

2.1 The Review's terms of reference require it to assess the legal framework governing collective investment schemes and the extent to which the existing law promotes adequate and effective protection of the interests of investors, commercial stability and efficiency in capital raising and formation. Particular issues that the Review has been asked to address include

- what disclosures should be made to investors by operators
- what prudential arrangements should be imposed on participants in the industry
- the powers, duties and responsibilities of the operators of collective investment schemes
- the appropriate controls over buy-back and redemption of investments.

This chapter discusses regulation in financial markets and the policies and principles underlying the review in this report. It presents the Review's objectives in relation to investor protection, commercial stability and efficiency in capital raising and formation.

Regulation

Role of regulation

2.2 The Review accepts it as fundamental that the level of regulation should be kept to the minimum consistent with the achievement of other policy goals. Because of the significance of collective investment schemes to the national economy, there is an understandable tendency on the part of some commentators to assess existing or proposed regulatory frameworks solely from the standpoint of whether they promote economic efficiency. However there are other policy considerations involved.

> [T]heft has been outlawed to protect individuals, not simply because of its economic consequences. Similarly modern trade practices and consumer protection laws are motivated by a desire to prevent exploitation of the individual by those with greater economic power, greater access to information or greater bargaining strength. More adequate and effective company and securities laws are required on grounds of fairness and commercial morality.[1]

While the Review accepts that a principal criterion for judging the regulation of fund raising activities such as collective investment schemes is an economic one — does the regulation promote efficiency? — it also accepts, as the Rae Committee did, that regulation has an important role in protecting the interests of investors and the wider community from the consequences of low standards of corporate governance. Not to act to protect those interests would impose economic and other

1. Rae Report, 471.

costs on these investors, and on the community as a whole. In some cases these costs may be difficult to quantify. But an assessment of a regulatory regime which ignored them would be seriously incomplete.

Responsibility for regulation

2.3 Who has ultimate responsibility for regulating the collective investments industry is an important issue for the Review. The law could provide for regulators to exercise, for the benefit of the community, quite extensive coercive powers. It may give them power to deny industry participants access to the market, or to set terms and conditions under which industry participants must operate. The law could also authorise regulators to exercise, on behalf of investors, powers that the investors would have difficulty exercising themselves. At present, the ASC has some of these powers. Some industry participants (trustee companies and others who act as trustees or investor representatives) have other powers, either under the law or because of their market position. In view of the significant role that collective investment schemes play in the national economy, ultimate responsibility for ensuring the establishment and operation of an adequate regulatory framework must rest with the Commonwealth. Many of the powers needed for effective regulation will be coercive, involving penalties for non-compliance. These should only be exercised by the state — in this case, the Commonwealth, through the ASC and other relevant agencies. The Commonwealth should not rely on industry self-regulation. It should not hand over responsibility for the regulatory framework to participants in the industry to enforce on behalf of the community.

Protection of investors

An essential policy aim

2.4 The principal aim of the Review is to ensure adequate and effective protection for investors. The Review met widely differing views on what 'investor protection' means. For some it seems to mean that investors will not lose their initial investment, or that they will always receive a positive rate of return on their investment. Given the nature of collective investment schemes, this cannot be correct. To understand what 'investor protection' means in the context of collective investment schemes requires a clear understanding of the risks that investors in these schemes face.

Investor protection and risk

2.5 Investors in collective investment schemes face the risk that some or all of their investment may be lost. The nature and extent of this risk will vary with the kind of investments the scheme makes. However, for all schemes, there are three kinds of risks that may result in a loss by investors (either by reduced value of their investment or by a reduced return on their investment):

- investment or market risk — the risk that the investment will decline in value, either because the market as a whole declines in value or because the particular investments of the scheme decline in value

- institution risk — the risk that the institution which operates the scheme will collapse
- compliance risk — the risk that the operator of a scheme will not follow the rules set out in the scheme's constitution or the laws governing the scheme, or will act fraudulently or dishonestly.

Protecting investors in collective investment schemes

2.6 ***Protection against investment risk.*** Collective investment schemes appeal to a wide range of investors with different investment preferences. Some schemes invest in assets that can be described as highly speculative; others offer a relatively secure investment. The investment risk of a scheme refers to possible variations in an investor's rate of return caused by fluctuations in the resale value of the scheme's assets. One way of reducing investment risk is to impose stringent investment controls on collective investment schemes. These might include, for instance, a requirement for schemes to diversify investments or a prohibition on certain classes of investment. The law governing collective investment schemes cannot — and should not — try to eliminate the investment risks facing investors. If the law attempted this, it would fail. Investors would be deluded into thinking they could not lose their money. Many of the innovative financial products marketed to investors through collective investment schemes would no longer be viable. Investors would have no choices and no ability to accept greater risks for the opportunity of obtaining greater returns. However, the law can and should ensure that investors are given all the information they need to understand fully, and to judge for themselves, the level of investment risk associated with any scheme so that they can choose, with full knowledge, the scheme that best suits their investment objectives.

2.7 ***Protection against institution risk.*** Investors may be attracted to a particular collective investment scheme because of the perceived skill of the scheme operator.[2] Institution risk refers to the risk that the operator will collapse, resulting either in transfer of the operation of a scheme to another operator which some investors would not have chosen, or in the collapse of the scheme. The law cannot ensure that the operators of collective investment schemes will never collapse. To ensure that the collapse of a scheme operator does not result in the loss to investors of any of the scheme's assets, the law should ensure that the scheme's assets are isolated from the collapse of the scheme's operator. What, if any, regulatory controls ought to be imposed to reduce the risk of collapse of the scheme operator is a separate issue.

2.8 ***Protection against compliance risk.*** The law can and should deal with the risk that a scheme operator may not adhere to the scheme's own rules or to the laws governing collective investment schemes, and with the risk that the scheme operator will act fraudulently or dishonestly. The law governing collective investment schemes cannot prevent all instances of non-compliance and dishonesty. It can, however, establish rules to reduce the risk of non-compliance to an acceptably low level. A focus on compliance is a particularly important

2. In unit trusts some investors may be influenced by the identity of the scheme's trustee but more are likely to be attracted by the reputation of the scheme manager.

consideration for the regulatory framework for collective investment schemes because of the limited powers of investors, the restricted investment objectives of many of these schemes and the risk that operators may take actions that are not in the interests of investors. One example is the risk that a scheme operator will try to overpay itself for fees incurred in the management of the scheme. Likewise, the ability of investors to have confidence in the regulatory regime, which is an essential precondition for the Review's goal of promoting commercial stability, requires that investors be protected from unlawful activities of scheme operators. This element of investor protection may also include the need to ensure that, if investors are divided into classes, investors in one class are treated fairly compared with those in another class.

Investor protection and prudential supervision

2.9 Prudential supervision can help to increase the level of protection against institution risk and market risk.[3] In the collective investments industry, prudential regulation can involve either specifying necessary attributes of scheme managers or placing controls on the schemes themselves. There is a variety of prudential measures that could be adopted, including

- requiring that intending scheme operators have the resources to adhere to requirements imposed by law
- imposing standards of honesty and character on operators
- imposing minimum working capital requirements on operators
- imposing minimum liquidity standards or redemption controls on schemes.

Working capital requirements for scheme operators, for example, can reduce the risks associated with the cash flow pattern of the operator. Liquidity and redemption controls on schemes can help to reduce the likelihood of loss to investors caused by mismanagement of scheme assets by the operator. Such prudential controls would impose some costs on collective investment schemes, reduce the range of investment opportunities and could narrow unnecessarily the options available to investors, as some schemes and their operators may not be able to meet the prudential standards. While the new regime should establish minimum standards with which all operators and schemes, whatever their nature, must comply, the standards should not be so strict as to reduce significantly the options available to investors or to erect unwarranted barriers to entry.

Investor protection and disclosure

2.10 As collective investment schemes, and the way in which they are marketed, become more complicated, it is more likely that schemes will be marketed to individuals who lack the financial sophistication to assess the risks involved in investing in them. The law cannot ensure that all intending investors understand the nature of the scheme. It can, and should, impose rules to ensure that

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3. Prudential regulation refers to controls over the way in which scheme operators are structured and how they conduct their business.

- the operator of the scheme gives investors all the information relevant to the assessment of risk that the operator has available to it
- information is presented in a clear and comprehensible way and is not misleading.[4]

The focus of the law should be to ensure that investors are as well informed about the scheme as the operator of the scheme.[5] Disclosure by scheme operators is an important way of protecting investors by providing them with information which they need to make a decision about the investments available but which would otherwise not be provided. The need for mandatory disclosure rules tailored to the needs of unsophisticated investors becomes greater where there is neither a well established secondary market with readily observable securities prices nor a large and reliable investment advice system that offers unsophisticated investors professional advice which may be used by investors before making an investment decision.

Investor protection, adequate investor rights and the regulator

2.11 *The role of the investors.* Because of the nature of collective investment schemes, investors must play an important role in ensuring that their interests are protected. What precisely that role should be needs to be considered in the light of investor preferences for the balance between involvement and external supervision by a government regulator[6] and the inherent difficulties facing investors who want to act for themselves. The Review has considered a range of self-help remedies in making its recommendations regarding investor rights. It has taken into account the costs and other problems involved in collective action by groups of disparate people.[7]

2.12 *The role of the regulator.* The regulator has an independent role in ensuring the proper and effective working of the regulatory regime. It also plays a significant role in ensuring that the rights of investors are able to be enforced. The regulator should be able to exercise, on behalf of investors, powers the investors would have difficulty enforcing because of the cost or difficulties in obtaining the necessary information. The Review has considered a variety of cases where intervention by the regulator on behalf of investors is warranted to ensure their legitimate interests are properly protected.

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4. Disclosure documents containing a large amount of information, but with important matters lost in a mass of detail, would not be clear or comprehensible. An example of misleading advertising is a collective investment scheme using the name or logo of a familiar financial institution to suggest that that institution 'backs up' the scheme when the institution does not in any way guarantee the investment.
5. For a discussion of rationales for mandatory disclosure requirements see M Blair 'The Debate Over Mandatory Corporate Disclosure Rules' (1992) 15 *UNSWLJ* 177.
6. See ch 3.
7. See 11. For a discussion of the collective action problem facing investors and the alternative solutions see M Blair & I Ramsay 'Collective investment schemes: the role of the trustee' (1992) 1(3) *The Australian Accounting Review* 10.

The Review's approach

2.13 ***Adequate investor protection.*** The Review has framed its recommendations so as to instil in investors generally a well founded confidence that the law will protect them against being exploited by scheme operators or others. To this end the Review has considered and made recommendations on

- mandatory disclosure rules
- appropriate deterrents and remedies concerning fraudulent or misleading behaviour on the part of scheme operators or other persons involved in schemes
- controls to resolve potential conflicts of interests between scheme operators and investors, for example, concerning excessive fees and related party transactions
- the powers available to the regulator
- compliance by scheme operators with both the scheme constitution and the collective investments legislation.

Many investors in collective investment schemes are commercially unsophisticated investors and rely heavily on information supplied by the promoter of the scheme to assess the performance of the scheme or the state of their investment. Many, perhaps most, do not wish to be involved in day to day management of their investment funds. This investor preference has been taken into account by the Review in developing its recommendations.

2.14 *Minimising risk.* In formulating its recommendations, the Review has weighed carefully the need for investor protection and possible losses in efficiency. It has concluded that the law should not protect investors from pure investment risk. Investments necessarily entail taking commercial risks. Before entering a scheme, investors must have available to them all relevant information about the investment risk involved. The Review has focussed on developing a legislative framework that, subject to cost-benefit considerations, minimises the compliance risk faced by investors in collective investment schemes and maximises their ability to make properly informed decisions.

Promoting commercial stability

Introduction

2.15 Stability means the avoidance of major fluctuations in the level of and value of investments. Stability contributes to investor confidence, and investor confidence in turn promotes stability. One goal of the regulatory regime ought to be to enhance investor confidence by minimising the risks of unexpected fluctuations or collapses in investment schemes.

Investor confidence essential for commercial stability

2.16 A necessary condition for commercial stability in the collective investment industry is the confidence of investors that

- they are adequately protected against exploitative behaviour by scheme operators
- the industry operates efficiently and effectively.

Lack of confidence on the part of investors may mean that they will be more likely to withdraw their money from collective investment schemes on receiving adverse information concerning the scheme operator. This may destabilise schemes and may have detrimental effects on financial markets and the economy as a whole. The level of commercial stability is therefore closely linked to investor protection and efficiency. A recent example of instability in the Australian collective investments industry has been the collapse of the unlisted property trust market. The instability arose because the illiquid nature of the underlying assets of property trusts was not matched to the rate at which investors could redeem their claims or to investor expectations.

The failure of individual schemes and commercial stability

2.17 The failure of individual schemes will not necessarily lead to instability in the collective investments industry. One or more isolated failures may be of little consequence to investors in similar collective investment schemes, particularly where they recognise that the failure was due to poor investment decisions on the part of the particular scheme operator. There are clearly occasions, however, where the failure of a scheme is believed by investors to be a function of an inadequate regulatory framework. Such a failure can cause investors in similar schemes to attempt to withdraw from their schemes, causing these schemes to collapse. This is known as 'contagion'.

The Review's approach

2.18 The Review acknowledges the importance of maintaining commercial stability in capital markets. A regulatory regime which does not provide incentives to encourage this stability is likely to reduce investor confidence and hence the willingness of individuals to commit their savings to collective investment schemes. This reduces the overall level of savings in Australia and thereby either increases our reliance on overseas funds to maintain our current levels of investment or leads to falls in the levels of investment and, consequently, a decline in economic growth. Even if the level of savings is not diminished, commercial instability in collective investment schemes may result in a distorted pattern of savings and investment which would inhibit Australia's economic growth. The Review recognises that it needs to consider the impact which its recommendations could have on the stability of the collective investments industry and has framed its recommendations accordingly.[8]

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8. One aspect of this is the question how to manage the transition from the current regime to that proposed in this report: see ch 16.

Efficiency in capital raising and formation

The importance of efficiency

2.19 Maximising the efficiency ot capital formation is important for Australia's economic well being. Clearly, if the regulatory regime imposes more costs on fund raisers than are necessary to provide the appropriate level of investor protection, the system is inefficient. As a consequence some investments may not be undertaken because the rate of return generated would not be high enough to make the investment attractive. Australia's economic growth will be reduced as a result.

Three types of efficiency

2.20 *Introduction.* There are three types of efficiency in capital raising and formation:

- allocative efficiency
- operational efficiency
- dynamic efficiency.

Securities regulation should be framed so as to promote each of these.

2.21 *Allocative efficiency.* Allocative efficiency in the context of collective investment schemes refers to the extent to which the economic system directs savings into the highest yielding investments. Information flows between participants in the industry play an important role in this. There is considerable support for the view that market forces, if left unfettered, will not result in the necessary level or type of disclosure in capital markets.[9] Proponents of this view argue that, to assess which investments offer the highest yields, investors need access to information above and beyond what scheme operators would otherwise be willing to provide. In other words, they contend that the allocative efficiency of the market for collective investment scheme investments may be improved by mandatory financial and other disclosure rules for scheme operators. However, regulation that stifles the market by unnecessarily reducing the possible returns to investors needs to be avoided.

2.22 *Operational efficiency.* Operational efficiency refers to how schemes are managed. One way to enhance the operational efficiency of collective investment schemes would be to impose requirements for particular corporate governance standards, such as the involvement of non-executive directors. The extent to which this kind of regulation should be imposed is an issue for the Review. Alternatively, market forces could be relied on to provide incentives for improved operational efficiency. For this to work effectively, investors must be able to discipline scheme operators for inefficient behaviour, including replacing them if that becomes necessary.

9. See, eg, JC Coffee 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717.

2.23 ***Dynamic efficiency.*** Dynamic efficiency refers to the capacity of a system to adapt to changing needs, generate innovations and raise productivity. The dynamic efficiency of the collective investments industry may be promoted, for example, by allowing scheme participants flexibility in the legal form and administrative arrangements that they adopt. Conversely, certain forms of regulation, such as a prohibition on certain classes of investment, may impair the ability of schemes to adapt to changing market conditions.

The importance of competitive neutrality for efficiency

2.24 ***The principle.*** A fundamental principle of economics is that competition is essential if a market is to produce an efficient outcome. This principle applies to securities markets as it does to markets for goods and services. There may be impediments to competition if different institutions offering functionally similar financial products face different regulatory regimes. Indeed, if different regulatory regimes exist, the offerors of functionally similar financial products may not perceive themselves as potential competitors. Potential investors also may not consider the comparative costs and benefits of investment in each product.

2.25 ***Functional versus institutional regulation and competitive neutrality.*** Traditionally the regulation of fund raising schemes has been based on the type of institution operating the scheme. This approach assumed that the kinds of risk borne by investors depended principally on the type of institution raising the funds, and that investors were choosing among different institutions offering the same product rather than among different (though functionally similar) products. In recent years new types of financial products have been developed. There has also been a trend toward financial conglomeration resulting in the emergence of financial 'supermarkets'. As a consequence of these developments, the kinds of risks facing investors no longer necessarily coincide with the kind of institution raising the funds.[10] Major inconsistencies in the regulation of functionally similar financial products as a result of the current regulatory regime relate to

- disclosure requirements
- capital requirements of offerors
- investment controls
- liability of offerors
- taxation treatment.

Differential regulation of this kind is likely to result in a reduction in effective competition and therefore in overall economic efficiency. If it is accepted that fund raising vehicles performing the same function should not be regulated differently merely because they are operated by different institutions, a functional rather than an institutional approach to regulation is required. A regulation by function approach should increase competition by promoting a 'level playing field'.

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10. Life insurance companies, which have traditionally offered investors products that are capital guaranteed (such as term life insurance and endowment assurance policies), now offer investment products in which the investor bears the investment risk. Yet the regulation of this type of fund raising activity by these institutions still incorporates many features that were developed for 'traditional' insurance products.

The Review's approach

2.26 ***Review of existing requirements.*** The Review accepts as important the economic arguments in favour of constructing a regulatory regime for collective investment schemes which aims to maximise the efficiency of the schemes and ensures investors have the widest possible choice. The Review has examined thoroughly the existing legislative requirements pertaining to the various forms of collective investments, so as to ensure that collectively they represent the best way of achieving efficiency in capital raising and formation and maximising investor choices.

2.27 ***Different regulatory regimes.*** The approach of the Review has been to ensure that, wherever possible, the law promotes competitive neutrality between different legal structures that provide functionally similar services to investors. This does not require the details of the regulatory regime applying to each type of functionally similar scheme to be identical. The regulatory impact should, however, be the same. The Review has taken into account the need to balance the benefits of establishing a competitively neutral regulatory regime with the potential for commercial instability in areas such as the regulation of investment schemes offered by insurance companies, friendly societies and statutory trustee companies. The Review has consulted widely on the appropriate legal framework for these schemes.