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Funds Management & Financial Services: Quarterly Review

August 2013

Editorial

Welcome to the August 2013 edition of Thomsons' quarterly snapshot of legal developments in the funds management and financial services sector.

Since our last edition, ASIC has released some significant updates to its policy. In particular, it has refreshed its policy on registered managed investment scheme constitutions and released its new financial requirements for wholesale trustees and custodians.

We have also seen the release of information about the 'limited' Australian financial services licence, which will replace the accountant's exemption for giving advice on self-managed superannuation funds.

In addition, some significant court decisions have been handed down. For example, in October 2012, we reported on the decision in *Australian Securities And Investments Commission V Wellington Capital Ltd and Others (2012)* 91 ACSR 514 which involved the demerger of assets from the Premium Income Fund (**PIF**), which is managed by Wellington Capital Limited (**Wellington**). In that case, the Australian Securities and Investments Commission (ASIC) was unsuccessful in challenging whether Wellington was legally able to distribute shares, as opposed to cash, to the unit holders in PIF. The action was dismissed by a single judge of the Federal Court and ASIC was ordered to pay Wellington's costs. ASIC appealed, and the full court of the Federal Court overturned the primary judge's decision.

In *Jordan v HLB Mann Judd Wealth Management (NSW) Pty Ltd*, a single judge of the Federal Court dismissed an application against a financial planner for negligence and misleading and deceptive conduct relating to recommendations to invest in two Basis Capital funds which ultimately failed.

You will find more information about these significant developments inside this edition. I hope you find it informative.

Kind regards,

Chris Mee

Special Counsel
+61 7 3338 7589
cmee@thomsonslawyers.com.au

Inside this edition

Articles

Sector developments

Important dates

13 September 2013: Submissions close on the consultation draft of the final element of the Investment Manager Regime.

30 September 2013: Comments close on ASIC consultation paper 212 *Licensing: Training of financial product advisers – Updates to RG 146.*

1 October 2013: All new applications to register a managed investment scheme must comply with ASIC's updated policy on scheme constitutions in Regulatory Guide 134 *Managed investments: Constitutions*

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Scheme constitutions: ASIC updates its policy

In brief:

- ASIC has updated its policy on registered scheme constitutions.
- From 1 October 2013, applications to register schemes will need to comply with the new requirements.
- Provided existing scheme constitutions comply with ASIC's old policy, ASIC will not take action to de-register the schemes if they do not comply with the new policy from 1 October onwards.
- The new policy provides greater flexibility in unit pricing and removes some unnecessary regulatory duplication.

The Australian Securities and Investments Commission (**ASIC**) has completed its review of its policy on the content requirements for the constitutions of registered schemes by releasing an updated version of Regulatory Guide 134 *Managed investments: Constitutions* (**RG 134**).

Important features to note about the updated policy

The following are some of the key policy matters now covered in the updated RG 134:

Transaction costs

Responsible entities may continue to add and deduct transaction costs from unit pricing formulae and still comply with the content requirements. The obligation to maintain a unit pricing policy and offer to provide it to prospective investors in product disclosure statements (**PDSs**) has not changed.

Rights issues

ASIC has removed the obligation that the record date for rights issues be no longer than 20 business days before the date of the offer. It is now up to the responsible entity to determine the record date.

ASIC has also removed the current requirement that the constitution must set out the maximum percentage discount at which an interest can be issued under a rights issue and instead allows the responsible entity to determine the issue price.

In addition, the issue of interests no longer has to be made to all members (other than foreign members), the interests offered do not have to be in the same class, the price does not need to be the same and the offer does not need to be made at substantially the same time.

Distribution reinvestment plans

ASIC has also removed some of the restrictions around distribution reinvestment plans. Gone are the requirements under ASIC class order 05/26 *Constitutional provisions about the consideration to acquire interests* (**CO 05/26**) that the issue of interests under a distribution reinvestment plan must be made to all members. Also gone are requirements that the price offered needs to be the same and that the interests offered are in the same class. ASIC also no longer requires a scheme's constitution to set out the maximum percentage discount at which an interest can be issued under a distribution reinvestment plan.

Negotiated fees

ASIC has removed the unnecessary duplication of the relief in ASIC class order 03/217 *Differential fees* (**CO 03/217**) and elements of CO 05/26 which permits a responsible entity to negotiate lower fees with wholesale clients. Responsible entities are now only required to comply with CO 03/217.

Stapled securities

Responsible entities will no longer have to apply for individual relief to allow them to allocate the issue price of a stapled security between its component parts because of amendments made by ASIC to the operation of CO 05/26.

Powers and rights of the responsible entity

ASIC has confirmed that it is not necessary for the investment strategy of a fund to be set out in the scheme's constitution. In line with current commercial practice, ASIC expects that responsible entities will set out the investment strategy for the scheme in the PDS for the offer of interests in the scheme.

In respect of a responsible entity's right to be paid fees and receive an indemnity from scheme property, ASIC has reconfirmed its current position that a constitution ought expressly state that any right to be paid fees or receive indemnification from scheme property is subject to proper performance by the responsible entity. ASIC states that as an alternative, a constitution which includes a provision to the effect that where there is an inconsistency between the constitution and the *Corporations Act 2001* (Cth) (**Corporations Act**), the Corporations Act prevails, will satisfy the requirement under the law that any right to be paid fees or to be indemnified must be specified in the constitution.

Importantly, ASIC is of the view that the law does not permit the payment of fees in advance because such a provision would be inconsistent with the right to a fee being only available for proper performance of the duty to which it relates.

Complaints handling

ASIC considers that a scheme's constitution needs to address complaints handling for both retail and wholesale clients. Whilst acknowledging that AFS licensees (including responsible entities) who provide services to retail clients are required under section 912A(2) of the Corporations Act to have in place an internal dispute resolution procedure that complies with ASIC's requirements, ASIC believes that a responsible entity's obligation to include in a scheme's constitution the method by which complaints may be made by members extends to wholesale as well as retail client members. To avoid unnecessary duplication, ASIC says that a scheme constitution can include a provision that the responsible entity will comply as an AFS licensee with the dispute resolution requirements in section 912A(2). However, such a provision will only satisfy the content requirements in part because the procedure for dealing with wholesale clients needs to be included also.

Withdrawal rights

ASIC considers that the following key information about the withdrawal process must be set out in the constitution:

- how the withdrawal rights are exercised;
- any amount that will be paid or given to members;
- restrictions on dealing with withdrawal requests; and
- ceasing to be a member.

Importantly, ASIC believes that a scheme constitution should not contain a provision that has the effect of allowing the responsible entity to set out the circumstances in which it may suspend the right to withdraw in another document (such as a PDS).

Winding up

ASIC considers that the following key steps in the winding up process should be included in a scheme constitution:

- dealing with assets, liabilities and scheme property;
- the distribution of proceeds;
- costs of winding up; and
- additional payments by members.

ASIC says that the constitution should identify the party who will bear the costs of a winding up and in what priority this will be paid.

Whilst CP 188 contained a proposal that the constitution of a scheme can include a provision that permits the responsible entity to postpone the realisation of assets of the scheme on winding up for as long as it thinks fit, provided the provision is made subject to the responsible entity's duties to act in the best interests of members etc, the updated RG 134 does not quite go that far. The final policy just makes an acknowledgement that a responsible entity may need to sometimes legitimately postpone the realisation of the scheme's assets on winding up to maximise the net proceeds of realisation attributable to members.

Independent audit and incorporation by reference

ASIC has continued its current policy that a scheme constitution needs to include a provision that provides for an independent audit of the final accounts to be conducted by a registered company auditor after a scheme is wound up. It has also reinforced its unpublished policy that a constitution should not include references to documents that can modify or replace the provisions of the constitution, thereby undermining the consideration of the constitution by ASIC.

Responsible entities who wish to rely on CO 13/655 must publish and maintain on their websites a notice that they have elected to rely on that instrument.

Application of the policy to existing schemes

ASIC says it will only apply updated RG 134 when assessing constitutions lodged as part of an application to register a scheme from 1 October 2013. It will not deregister an existing scheme or take any action against the responsible entity or its officers on the basis the constitution of an existing scheme does not comply with the Corporations Act (as it might for schemes registered after 1 October 2013), as long as the constitution meets the requirements of the old RG 134.

Thomsons Lawyers can assist you comply with ASIC's new requirements, including the circumstances where you may wish to apply to new policy to your existing scheme constitutions. Please contact Chris Mee for further information.

Chris Mee
Special Counsel
+61 7 3338 7589
cmee@thomsonslawyers.com.au

Increase in capital requirements for wholesale trustees and custodians

In brief:

- Trustees of wholesale schemes will be required to hold NTA amounting to the greater of $150,000 and 10% of average revenue, unless they appoint an external custodian which meets the new requirements.
- Custodians and responsible entities who undertake self-custody will be required to hold NTA amounting to the greater of $10 million and 10% of average revenue.
- New cash flow and audit obligations apply, including quarterly approval of cash flow projections by the board.
- The new financial requirements will apply from 1 July 2013 for new licensees. For existing licensees, there will be a one year transition period and compliance will be required from 1 July 2014.

ASIC has increased the financial requirements for custodians and trustees of wholesale managed investment schemes. ASIC class order 13/761 *Financial requirements for custodial or depository service providers* (**CO 13/761**) and ASIC's updated regulatory guide 166 *Licensing: Financial requirements* (**RG 166**) contain the changes.

NTA requirements

Under the changes, custodians are required to hold net tangible assets (**NTA**) amounting to the greater of $10 million and 10% of average revenue. Providers of custodial and depository services who meet the definition of 'incidental provider', such as most trustees of wholesale funds, are required to hold NTA amounting to the greater of $150,000 and 10% of average revenue unless they appoint a third party custodian which meets these requirements.

An 'incidental provider' is a financial services licensee that is authorised to provide a custodial or depository service:

- that does not provide any custodial or depository services other than services which:
  - are a need of the person to whom the services are provided because of, or in order to obtain the provision of other financial services by the licensee or its related bodies corporate; and
  - do not form part of an IDPS; and
- whose custodial or depository services revenue is less than 10% of its financial services business revenue.

ASIC has continued its old policy that an example of an 'incidental provider' may include the trustee of an unregistered scheme that holds financial products as part of the scheme on behalf of clients, which occurs after the trustee has provided financial product advice and/or dealing services in respect of those interests on behalf of the clients.

The NTA must be held in 'liquid assets' with at least 50% in cash or cash equivalents. 'Liquid assets' means cash or cash equivalents and assets that a licensee can reasonably expect to realise for market value within six months, that are free from encumbrances and, in the case of receivables, free from any right of set-off.

In the circumstances where a third party custodian is appointed and it meets the NTA requirements, the new rules do not exempt the trustee from maintaining surplus liquid funds of $50,000 where that requirement is triggered.

Also, trustees must hold a 'reasonable belief' that any custodian it appoints meets the requirements. ASIC says that trustees are taken to have this belief if they receive a written assurance from the custodian each year that they meet the NTA requirements and there is no reason for the trustee to suspect that the custodian does not continue to comply with the NTA requirements.

Cashflow projections

All licensed custodial and depository service providers are subject to new requirements regarding the preparation of cash flow projections and liquidity, including requirements to:

- prepare a cash flow projection over at least 12 months;
- update this monthly or more frequently if there is a material change; and
- have the cash flow projection approved at least quarterly by the board as satisfying ASIC's requirements.

New audit requirements

A licensee's annual audit must include an opinion on the licensee's compliance with the NTA requirements (including its composition), the cashflow requirements and, where the licensee is relying on being an 'incidental provider', that the revenue from providing custodial services is less than 10% of its financial services business revenue.

Implementation

The new financial requirements will apply from 1 July 2013 for new licensees. For existing licensees, there will be a one year transition period and compliance will be required from 1 July 2014.

Wholesale trustees currently are required to hold $50,000 in surplus liquid funds if they hold $100,000 or more of client property. So the new requirements will be a marked increase in the level of capital they are required to hold. In addition, 50% will need to be held in cash and 100% in liquid assets. For custodians and responsible entities performing self-custody, the capital requirement will effectively double.

Thomsons Lawyers can assist you to understand how to comply with the new requirements. Please contact Chris Mee for further information.

Chris Mee
Special Counsel
+61 7 3338 7589
cmee@thomsonslawyers.com.au

Accountants' limited AFS licence: is it right for your practice?

As part of the Future of Financial Advice (**FOFA**) reforms, the exemption in the *Corporations Regulations 2001* (Cth) which allows accountants to give advice about self-managed superannuation funds (**SMSFs**) without holding an Australian financial services (**AFS**) licence will be repealed on 1 July 2016. This means that accountants who wish to continue giving advice to their clients about SMSFs will need to obtain an AFS licence.

To facilitate accountants moving to the AFS licensing regime, the Federal Government has created a new form of AFS licence referred to as a 'limited' AFS licence.

But what is the difference between a 'limited' AFS licence and a 'full' AFS licence? Which one best covers the services you want to provide to your clients? What obligations do you not need to comply with under a 'limited' AFS licence and if you are going to get an AFS licence, why not just get a 'full' AFS licence?

Set out in the following table is a comparison of the features of a limited AFS licence compared with a full AFS licence:

	Full AFS licence	**Limited AFS licence**
Financial services that can be provided	All possible authorisations are available.	Limited to: • providing advice on SMSFs; • providing advice on superannuation products in relation to a client's existing holding in a super product but only to the extent required for making a recommendation that the person establish an SMSF or advice on contributions or pensions under a super product; • providing 'class of product' advice on a range of financial products; and • arranging for a person to deal in an interest in an SMSF.
Organisational competence	The applicant must have responsible managers who hold the qualifications **and** have the experience set by ASIC in RG 105. There are five options which the nominated responsible managers can meet. Commonly, responsible managers meet the option which requires the responsible manager to have an undergraduate degree in a relevant discipline and a short industry course to meet the knowledge requirements, and three years out of the last five years' experience as a representative of an AFS licensee.	If the responsible managers nominated are 'recognised accountants', then they do not need to meet ASIC's *experience* requirements. They will, however, need to meet the *knowledge* requirements. If an entity obtains a limited AFS licence and nominate 'recognised accountants' as the responsible managers, then the entity is subject to a condition that three years after receiving its licence, ASIC can call on the entity to prove its responsible managers have the appropriate knowledge *and* skills.

	Full AFS licence	Limited AFS licence
Professional indemnity insurance requirements	If services are provided to retail clients, then professional indemnity insurance must be held.	No difference
Internal and external dispute resolution procedures	If services are provided to retail clients, then the licensee must have an internal dispute resolution mechanism and be a member of an external dispute resolution scheme.	No difference
Financial requirements	Solvency, cash flow projections and where client money is held, surplus liquid funds requirements apply.	No difference
Disclosure requirements	Financial services guides must be provided to retail clients and if personal advice is given, a statement of advice.	No difference
General licensing obligations	Licensees must, among other things, provide their services efficiently, honestly and fairly, manage conflicts of interest, comply with the financial services laws and the conditions on their licence.	No difference
Application fee	$1,522	No difference
Audit requirements	A registered company auditor must be appointed to undertake an annual audit of the licensee. A licensee must lodge its profit and loss statement and balance sheet annually.	If client money is not handled, then the limited AFS licensee can lodge a compliance certificate rather than an audit. However, the licensee will still need to lodge its profit and loss statement and balance sheet annually.
Application process	Lodgement of form FS01, core proofs and additional proofs.	No difference, other than the omission of the requirement that responsible managers lodge two business references with ASIC where those responsible managers are 'recognised accountants' and the application is made during the transition period (i.e., 2013 to 2016).

What financial services can I provide under a limited AFS licence?

The financial services you can provide to clients under a limited AFS licence are limited to the following:

- Providing financial product advice on SMSFs. 'Financial product advice' includes both 'general' financial product advice and 'personal' financial product advice. Personal financial product advice is where the provider of the advice has considered one or more of the client's objectives, financial situation and needs.
- Providing advice on superannuation products in relation to a client's existing holding in a super product but only to the extent required for making a recommendation that the person establish an SMSF or advice on contributions or pensions under a super product.
- Providing 'class of product' advice about the following financial products:
  - superannuation;
  - securities;
  - general insurance;
  - life risk insurance;
  - basic deposit products; and
  - simple managed investment schemes.

Financial products which have been excluded from this list include non-basic deposit products, derivatives, foreign exchange products, government debentures, managed investment schemes other than simple managed investment schemes, retirement savings account products and margin lending facilities.

'Class of product advice' is defined as financial product advice about a class of products but does not include a recommendation about a specific product in the class. For example, you may give a recommendation about term deposit products but not a specific recommendation about a particular term deposit product offered by a particular bank.

- Arranging for a person to deal in an interest in an SMSF. 'Arranging' refers to the process by which a person negotiates for, or brings into effect, a dealing in a financial product (e.g. an issue, variation, disposal, acquisition or application).

The new regime requires licensees to provide advice in accordance with the consumer protection provisions of the *Corporations Act 2001* (Cth) including the best interests duty obligation enacted through the FOFA reforms.

What is the application process?

A streamlined application process applies until 1 July 2016 to allow accountants to transition into the AFS licensing regime in recognition of their existing professional qualifications.

However, the application process is the same as for any other AFS licensee applicant other than the following:

- If the responsible managers nominated are 'recognised accountants', then they do not need to meet ASIC's experience requirements, which are generally three out of the last five years' experience in providing financial services. They will, however, need to meet the knowledge requirements. 'Recognised accountants' are those who hold a certificate of public practice issued by the Institute of Chartered Accountants in Australia or those who hold a public practice certificate issued by CP Australia Ltd or the Institute of Public Accountants.
- The requirement that responsible managers lodge two business references with ASIC where those responsible managers are 'recognised accountants' and the application is made during the transition period (i.e., 2013 to 2016).

This means that applicants must complete an ASIC form FS01, provide the core proofs required by ASIC and any additional proofs ASIC requires. Please click here to refer to our publication *Applying for an AFS licence: A Thomsons Guide* for more information about the application process.

What type of licence should I obtain?

Given the requirements associated with obtaining and holding a limited AFS licence and the limitations on the kind of services that can be provided under this licence, consideration should be given as to whether a 'full' AFS licence would be all that more difficult to obtain and maintain. The most significant relaxation for accountants during the transition period is the exemption from the experience requirement. However, it is possible for accounting practices to appoint experienced responsible managers on a contract basis for the first three years of holding an AFS licence as the practice principals themselves gain the relevant experience in providing financial services under an AFS licence to transition to the responsible manager roles.

If you are considering applying for a 'limited' AFS licence or are not sure about whether you might qualify for a full AFS licence, then we can assist you by:

- preparing the necessary proofs and lodging the application;
- reviewing proofs which you prepare;
- advising you on the authorisations that you require;
- advising you on the knowledge requirements for your responsible managers; and
- advising on your prospects of obtaining a limited or full AFS licence.

Please contact Chris Mee for further information.

Chris Mee
Special Counsel
+61 7 3338 7589
cmee@thomsonslawyers.com.au

Client fails in claim of negligence against financial planner

In brief:

- A client sued her financial planner for damages in respect of financial losses suffered when two investments in Basis Capital funds recommended by her financial planner failed.
- The court held that given the client's risk profile and the reasoning behind the decision to recommend the investments (which included reliance on independent research reports), there was no basis that the recommendations were negligent or wrongful.

In *Jordan v HLB Mann Judd Wealth Management (NSW) Pty Ltd*, a single judge of the Federal Court dismissed an application against a financial planner for negligence and misleading and deceptive conduct relating to recommendations to invest in two Basis Capital funds which ultimately failed.

Facts

The client was an unsophisticated investor who had received approximately $7 million as part of a matrimonial property settlement. After purchasing a family home with the proceeds, the client intended to invest about $5.5 million. She engaged HLB Mann Judd Wealth Management (NSW) Pty Ltd (**HLB**) to assist her invest the money.

After undertaking a risk profile assessment, HLB determined the client was between a balanced and growth risk profile. Accordingly, it recommended the following portfolio of investments:

Investment	Amount Invested $
Australian Equity	
Lonsec Model Income Share Portfolio	800,000
Ausbil Aust Active Equity Fund	200,000
BT Imputation Fund	200,000
IML Australian Share Fund	200,000
EleyGriffiths Group Small Companies Fund	52,500
International Equity	
Credit Suisse International Shares Fund	280,000
Russell Global Opportunities Fund	280,000
PM Capital Absolute Performance Fund	280,000
JB Were Global Small Companies Fund	197,500
Property	
AMP Core Property Fund	207,500
Hedge Funds	
Basis Aust-Rim Opportunity Fund	207,500
HFA Diversified Investments Fund	207,500
Fixed/Floating Interest	
Basis Yield Fund	330,000
Credit Suisse Global Hybrid Income Fund	250,000
Mariner Mortgage Trust	250,000
Cash Management	
Wrap Cash Account	207,500
Total	**4,150,000**

The Basis Capital investments both failed. Those funds were heavily invested in collateralised debt obligations and were one of the first victims of the global financial crisis.

The client alleged that HLB had breached contractual and tortious duties of care owed by them and that they had engaged in misleading and deceptive conduct or conduct that was likely to mislead and deceive by representing to her in the first statement of advice (**SOA**) she received that the investment recommendations which they made in that letter were suitable for her having regard to her risk profile when they were not. She also argued that HLB had breached section 945A of the *Corporations Act 2001* (which has since been repealed by the FOFA legislation) by making recommendations without a proper basis for doing so. HLB denied these claims.

The decision

The court found for HLB and dismissed the claim.

The judge described the following proposition as being at the heart of each cause of action: *"No ordinary skilled financial adviser should have recommended to [the client] that she invest $537,000 out of investments funds of $5.2-5.5 million in the two Basis Funds."*

In making his decision, Justice Foster made the following points:

- section 945A was not invoked because the client was a wholesale and not retail client;
- the risk profile assessment undertaken by HLB was reasonable;
- substantial evidence was led by HLB about how the investments were selected for the client, including reliance on information provided by research houses about the investments including the Basis funds;
- the Basis funds had performed well up to November 2006: they had delivered stable returns on a monthly basis over a considerable period and both of them were highly regarded in the market place;
- there was no evidence that HLB was aware or ought to have been aware of particular information which should have led it to arrive at a different assessment of the Basis funds and of the future prospects of those funds; and
- as the client had admitted during evidence that she had not read the SOA HLB had prepared for her, it was difficult to argue that she had been misled by the recommendations contained in it.

In addition to dismissing the application, the judge awarded costs against the client and also awarded an indemnity for costs from 24 May 2012, being the date the client rejected a settlement offer from HLB in the sum of $150,000.

Processes help establish a good defence

Although two of the recommended investments had failed and the client had suffered significant losses as a result, this case vindicated the advice process which the financial planner undertook to determine the portfolio of investments recommended. The case confirms the proposition that merely because a recommended investment fails, the advice provided is not necessarily negligent.

Financial advisers who can demonstrate rigorous investment selection processes and sound reasoning for investment recommendations will stand themselves in good stead in any potential claim for negligence.

Thomsons Lawyers can assist financial services licensees who face claims for misleading and deceptive conduct and negligent advice. Please contact Chris Mee for further information.

Chris Mee
Special Counsel
+61 7 3338 7589
cmee@thomsonslawyers.com.au

Court overturns decision about use of responsible entity's 'natural person' powers

In brief:

- The full Federal Court overturned the primary decision and agreed with ASIC that the fund manager had acted beyond its powers in demerging a significant proportion of the fund's assets without consent of the members.
- It is a fundamental principle of the law of trusts that a trustee must adhere to the terms of the trust, and a beneficiary may direct the trustee to transfer trust property to him or her but absent the consent of all beneficiaries it is not open to a trustee simply to transfer the trust property to the beneficiaries.

In October 2012, we reported on the decision in *Australian Securities And Investments Commission V Wellington Capital Ltd and Others (2012) 91 ACSR 514* which involved the demerger of assets from the Premium Income Fund (**PIF**), managed by Wellington Capital Limited (**Wellington**).

In that case, the Australian Securities and Investments Commission (ASIC) was unsuccessful in challenging whether Wellington was legally able to distribute shares, as opposed to cash, to the unit holders in PIF. The action was dismissed by a single judge of the Federal Court and ASIC was ordered to pay Wellington's costs.

ASIC appealed, and the full court of the Federal Court overturned the primary judge's decision. Wellington is seeking special leave to appeal to the High Court.

Facts

The units in PIF are listed on the market operated by National Stock Exchange of Australia Limited (**NSX**).

On 5 September 2012, Wellington announced to the NSX that it had sold $90.75 million in assets of the PIF to a newly incorporated entity called Asset Resolution Limited (**ARL**). The assets included seven mortgage loans for development projects located in Victoria, Queensland and New South Wales, $3.764 million in cash and all of the PIF's interest in the ASIC compensation claim relating to the MFS Group (now known as Octaviar) and the proof of debt in the liquidation of two MFS Group entities.

In return for the transfer of the assets, Wellington received 830,532,768 shares in ARL which represented 100% of the issued capital in ARL. Relying on general trustee powers in the PIF's constitution, Wellington then distributed those shares to PIF unit holders on a pro rata basis in accordance with their unit entitlements. The result of the transaction was the PIF unit holders now hold units in PIF and shares in ARL.

Wellington did not consult with or obtain the consent of the PIF unit holders to the distribution of the PIF's ARL shares to the PIF unit holders.

ASIC objected to the in specie distribution on the grounds that the constitution of the PIF did not permit it. ASIC applied to the court seeking a declaration that any the distribution of ARL shares to the PIF unit holders was invalid and that the ARL shares must remain the property of the PIF (and not individual unit holders).

The PIF constitution contains very broad trustee powers, which were typically included in constitutions for managed investment schemes established at the time PIF was established in 1999. Specifically, the constitution provided that "the Responsible Entity shall have all the powers in respect of the Scheme that is legally possible for an actual person or corporation to have and as though it were the absolute owner of the Scheme Property and acting in its personal capacity".

The constitution also included standard clauses relating to the method and formula for making distributions to unit holders. However, ASIC argued that these clauses only allowed for distributions to be made by cash and not in specie, and that these clauses qualified Wellington's general trustee powers.

Wellington relied on its general trustee powers as giving it the right to make the in specie distribution without unit holder consent, and that the clauses in the constitution about distributions of income did not limit these more general powers. Specifically, Wellington relied on the general trustee powers granting it the right to do whatever a company could do with the scheme's assets, and referred the court to the power of a corporation in section 124(1)(d) of the *Corporations Act 2001* (Cth) (**Corporations Act**) to distribute "any of the company's property among the members, in kind or otherwise".

The initial decision of the court

In the primary case, Justice Jagot agreed with Wellington's arguments relating to the construction of the constitution. She held that the lack of detailed provisions about an in specie distribution in the constitution (other than on a winding up) did not qualify Wellington's general trustee powers to do with the scheme assets whatever a corporation could do with its assets as if it were the absolute owner of those assets and acting in its personal corporate capacity. In addition, she said that when unit holders became members of PIF, they also became subject to and bound by the terms of the constitution which granted broad powers to the responsible entity. Unit holders must therefore accept the exercise of those powers.

The decision on appeal

On appeal, the full court of the Federal Court overturned the decision of the primary judge.

It said that:

- it is a fundamental principle of the law of trusts that a trustee must adhere to the terms of the trust;
- a beneficiary may direct the trustee to transfer trust property to him or her but absent the consent of all beneficiaries it is not open to a trustee simply to transfer the trust property to the beneficiaries;
- the steps taken by Wellington amounted to a partial retirement from office other than in accordance with the provisions of the Corporations Act and it did so without consent of the unit holders by handing over to them a substantial part of the PIF property which constituted approximately 41% of the assets of the PIF;
- shares in a company are an entirely different species of property from units in a managed investment scheme and the unit holders had become members of the scheme on the basis they would own units and not shares; and
- the distribution of the shares in ARL to the unit holders of the PIF was contrary to the terms of the constitution and was done without power.

Consequences for fund managers

Wellington has lodged an application for special leave from the High Court to appeal the judgement of the full Federal Court. Until this application has been resolved, fund managers should be cautious about how they use their broad powers under a scheme's constitution. If in doubt, it is always best to get a mandate from investors or a direction from the court about how your trustee powers can be used.

Please contact Chris Mee for further information.

Chris Mee
Special Counsel
+61 7 3338 7589
cmee@thomsonslawyers.com.au

Sector developments[1]

FOFA

Regulations to replace the accountants' exemption with a new form of limited licence

Please refer to the article above about this new exemption.

Managed investment schemes

ASIC releases updated guidance on constitutions of registered managed investment schemes

Please refer to our article above regarding this updated regulatory guide.

Capital protected products

ASIC released a health check of the Australian market for unlisted retail structured products promoted as having capital protection or a capital guarantee.

ASIC's key points were:

- Capital protection or capital guarantee products are complex.
- Complex products can be difficult for investors to understand.
- Those selling complex products need to ensure marketing and advice directed at retail investors are accurate.

[1] The material in this section contains edited excerpts from Government and ASIC media releases.

Report 340 '*Capital protected*' and '*capital guaranteed*' retail structured products (***REP 340***) found retail investors often have a poor understanding of these complex investments.

REP 340 highlights the way that some of these products are labelled, which ASIC says contains confusing or potentially misleading messages about the level of risk investors are exposed to.

Despite being labelled or described with terms such as 'capital protected' and 'conditional capital protected', some products have knock-out clauses and performance hurdles that may lead to investor losses. The report highlights concerns around:

- the accuracy and balance of advertising for these products;
- the labelling and description of reverse convertible products as offering 'conditional capital protection' or 'conditional protection'. The value of these investments is usually linked to the worst performing reference share, meaning investors could lose some or all of their money; and
- certain 'internally geared' structured products that are described as entailing a compulsory capital protected loan, where all of the investor's outlay is at risk of loss if reference assets don't perform. Where the investment exposure is 'notional', there may also be risks for investors who claim tax deductions on their payments.

ASIC to further improve hedge fund disclosure

ASIC will consider submissions from industry to refine the definition of 'hedge fund' due to concerns the current definition affected a number of funds that do not exhibit the same risks to investors as 'true' hedge funds.

In June 2012 ASIC released Class Order CO 12/749 *Relief from the Shorter PDS regime* (**CO 12/749**) which excludes hedge funds from the shorter product disclosure statement (**PDS**) regime. CO 12/749 was at the Minister's request and is a temporary exclusion (until 22 June 2014) to allow the Government to develop a permanent solution. However, under the class order if an issuer had issued a shorter PDS for a hedge fund on or before 22 June 2012, it can continue to use the shorter PDS.

In September 2012 ASIC released disclosure benchmarks and principles for hedge funds to improve investor awareness of product risks. These were to be disclosed against in any PDS dated on or after 22 June 2013.

CO 12/749 and Regulatory Guide 240 *Hedge funds:* ***Improving disclosure (RG 240)*** define a 'hedge fund' as a registered managed investment scheme that is:

- promoted as being a 'hedge fund', or
- exhibits two or more of the following characteristics of a hedge fund:
  - complexity of investment strategy or structure
  - use of debt
  - use of derivatives (subject to limited carve-outs)
  - use of short selling, or
  - has rights to charge a performance fee.

Following industry feedback, ASIC had decided to extend until 1 February 2014 the transitional relief to hedge fund issuers under CO 12/749 that had previously issued a shorter PDS on or before 22 June 2012.

ASIC will also extend the start of RG 240 until 1 February 2014 to allow consideration of submissions and continue engagement with a number of issuers. A PDS issued after 22 June 2012 for a fund which satisfies the definition of hedge fund must issue a longer form PDS.

ASIC consults on relief for the ASX Managed Fund Service

ASIC has released a consultation paper proposing relief for retail clients who apply for an interest in a registered simple managed investment scheme through the proposed ASX Managed Funds Service (**AMFS**).

The AMFS is a facility that allows investors to electronically apply for or redeem units in simple managed investment schemes that have been admitted to the service through brokers who are authorised to participate in the service.

Currently, under s1016A of the Corporations Act 2001, a retail investor must apply using an application form that accompanies a PDS, or an application form prepared and partly completed by an Australian financial services licensee.

ASX is seeking relief from the requirement of section 1016A as this would prevent the efficient functioning of the AMFS.

The proposed relief would apply to responsible entities of registered simple managed investment schemes for applications made through the AMFS.

The applications would be automatically processed using the ASX electronic settlement system, the Clearing House Electronic Sub-register System (CHESS).

The system will ensure investors are provided with a Product Disclosure Statement (PDS) before making any application to purchase an interest in the financial product available through the AMFS

Comments for Consultation Paper 208 ASX *Managed Funds Service: Relief from the application form requirement* are now closed.

Financial advice

Licensees urged to review and improve recruitment of new advisers

ASIC has warned financial services licensees to ensure they have robust recruitment processes in place when appointing representatives who have worked for a business ASIC has taken action against.

The warning follows ASIC action against licensees, including financial advisers and securities dealers, with ASIC becoming aware many of their representatives have moved to new licensees.

ASIC has stated that licensees generally have good compliance and governance standards and ensure representatives go through rigorous checking before taking them on. However, ASIC wants to make sure that all licensees are fully aware of the need to do this.

In many cases, ASIC says representatives of licensees against which ASIC has taken action will be adequately trained and competent, and comply with the financial services law. However, where representatives have come from an environment in which there was a culture of poor compliance or poor quality advice, appointing licensees need to take extra care to satisfy themselves that representatives are properly trained and monitored to address early any issues that might arise.

Licensees must:

- ensure migrating representatives are competent and adequately trained. It is important that they are effectively screened and their background checked;
- have adequate supervisory arrangements in place to identify and address deficiencies quickly; and
- have adequate financial, technological and human resources to supervise and monitor new representatives, especially in cases of business growth.

ASIC consults on enhancements to training standards

ASIC has released a consultation paper proposing enhancements to the training standards for people who provide financial product advice.

Consultation Paper 212 *Licensing: Training of financial product advisers – Updates to RG 146* (**CP 212**) outlines proposed changes to the training standards that are set out in Regulatory Guide 146 *Licensing: Training of financial product advisers* (**RG 146**).

CP 212 proposes to retain the current training standards in RG 146 as 'base level' standards, and to introduce two further regimes of training. These are proposed to come into effect in 2015 and 2019.

CP 212 proposes increases in the:

- generic knowledge requirements;
- specialist knowledge requirements for financial planning, securities and superannuation;
- skill requirements for personal advice; and
- educational level requirements.

CP 212 is also seeking feedback on the time frame for implementation of the proposed new training standards, and the appropriate training standards for personal sickness and accident insurance and consumer credit insurance.

Submissions to CP 212 close on 30 September 2013.

Derivatives and CFD providers

OTC derivatives reform— ASIC implements reporting regime

Final rules around over-the-counter (**OTC**) derivatives trade reporting obligations of financial institutions and the regulation of derivative trade repositories in Australia have been released. The regime is set out in a package of rules and guidance released by ASIC.

The Australian reforms have been designed to ensure, as far as possible, consistency with international requirements as well as to maximise the prospects of substituted compliance or sufficient equivalence judgments being reached by foreign regulators. This would help ensure that global markets remain open to Australian participants and infrastructures.

The final package follows consultations launched in March 2013. While final trade reporting rules are in place, final regulatory guidance on those rules is expected to be published in coming weeks. In the meantime, FAQ material on the trade reporting rules has been published.

The reporting rules establish which entities will need to report to trade repositories, what information will need to be reported, and when the reporting obligation will start for different classes of reporting entities and different instrument types.

Derivative trade repositories, or data warehouses, maintain electronic databases of records of derivative transactions. The rules for these repositories cover issues such as application requirements and conditions, the manner in which they must provide their services, and ASIC's approach to regulation of overseas-based repositories.

End users of OTC derivatives (i.e. those that are not financial institutions or intermediaries) will not be covered by the reporting regime. ASIC will consult on their reporting obligations later this year.

Anti-money laundering and counter terrorism financing

AUSTRAC has issued a consultation paper on possible enhancements to the requirements for customer due diligence (**CDD**).

In particular, the Australian Government invites industry and other stakeholders to make submissions detailing their views concerning:

- current business practices, including whether the international standards are already being met through use of these practices, and, if so, how;
- possible additional measures which may be required in order to meet the international standards;
- possible measures to simplify CDD obligations;
- estimated costs associated with compliance with the standards; and
- estimated benefits of compliance with the standards.

Submissions close on 30 September.

Taxation

Investment Manager Regime—Element 3 legislation out for consultation

The updated draft legislation for the third and final element of the Investment Manager Regime has been released for consultation.

The intention of the Investment Manager Regime is to provide certainty for the tax treatment of passive investments of certain foreign widely held funds, both in relation to offshore investments undertaken through the use of an Australian-based intermediary (conduit income), and into Australian assets.

The Investment Manager Regime consists of three elements. The first two elements were legislated in 2012, providing certainty about prior income years and the treatment of conduit income.

Under the draft legislation, gains of foreign funds from the disposal of portfolio interests in Australian assets will be largely exempt from Australian tax.

The exposure draft legislation and explanatory memorandum is available on the Treasury website. Consultation closes 13 September 2013.

Improving the new tax system for managed investment trusts

The Federal Government has announced two further changes to the proposed new tax system for managed investment trusts (MITs) in response to issues raised by the MIT industry in the course of consultation.

The changes relate to the under or over attribution of net income that is in excess of the de minimis threshold as well as the application of the proposed arm's length rule, which is aimed at preventing the circumvention of the eligible investment business (**EIB**) rules and protecting the corporate tax base.

The changes address concerns that the proposed tax treatment of the under or over attribution of net income may be unreasonable under certain circumstances when compared to the tax profile of many MIT investors as well as concerns that the proposed arm's length rule unnecessarily applies to certain services provided to a MIT by a related entity. To address these issues, the Federal Government will:

- allow an under or over attribution of net income in excess of the de minimis that is not caused intentionally by the trustee to be carried forward, subject to certain integrity measures; and
- carve out certain services from the application of the proposed arm's length rule between a MIT and an associate of the MIT.

For further information, please click here to contact our national Funds Management & Financial Services team.