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Funds Management & Financial Services: Quarterly Review

December 2012

Editorial

Welcome to the December 2012 edition of Thomsons' quarterly snapshot of legal developments in the funds management and financial services sector.

Over the last quarter, we have seen some significant court decisions as part of the fall-out of the GFC. In cases involving municipal councils investing in products issued by Lehman Brothers and ABN AMRO, the courts ruled that the councils' advisers engaged in misleading and deceptive conduct and breached their fiduciary duties to their clients. Standard and Poor's was also found to be negligent for ratings it issued on one of these products. The cases were victories for the "unsophisticated sophisticated investor" and should serve as a reminder to all advisers and fund managers that even though statutory disclosure requirements are reduced for wholesale clients, those clients are owed similar duties to retail clients.

In another legal battle between joint venture partners Westfield and UniSuper relating to the Karrinyup Shopping Centre in Perth, the High Court preserved the statutory right of a member of a registered scheme to call and vote at a meeting to wind up the scheme even where it was contractually bound to waive those rights. Caution must be exercised if you are relying on someone to "contract out" of their statutory rights as scheme members.

The Australian Securities and Investments Commission (ASIC) sought to prevent a demerger by Wellington Capital of assets in the Premium Income Fund and failed. The court ruled the responsible entity could divest assets in a scheme by making an in specie distribution of shares in a special purpose investment vehicle to members in the scheme.

We have also seen ASIC consult on changes to how managed investment scheme constitutions can operate and proposals to increase the capital requirements for wholesale trustees to a minimum of $150,000 and custodians to $10 million.

The investment criteria for the new Significant Investor visa have now been released. The visa allows a pathway for permanent residency for migrants who invest $5 million or more into certain investments, including complying managed funds. If the government's estimate that 700 visas will be issued annually comes to fruition, then there will certainly be a significant boost for fund managers and advisers in Australia.

You will find more information about all of these decisions and issues in our quarterly review. We hope you find it informative.

Wishing you and your family a merry Christmas and a prosperous 2013!

Regards,

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Important dates

21 December 2012: Submissions close on Treasury's draft regulations for the new limited financial services licence for accountants.

14 January 2013: Consultation period closes on ASIC Consultation Paper 194: *Financial requirements for custodial or depository service providers*

31 January 2013: All OTC derivatives issuers to comply with ASIC's new financial requirements.

15 February 2013: Submissions close on Treasury's proposals paper on the implementation of Australia's G20 over-the-counter derivatives commitments

27 February 2013: Thomsons hosting the Compliance Forum in Melbourne.

February 2013: ASIC to release final guidance on conflicted remuneration.

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Lehman Brothers, ABN AMRO, S&P and the unsophisticated sophisticated clients

Wholesale vs retail clients

In January 2011, Treasury issued an options paper on whether the distinction between retail and wholesale clients should be changed. In large part, this paper was issued as a result of problems with the definition of "wholesale client" exposed during the GFC as clients who did not have the necessary experience investing in complex financial products were able to access these on the wholesale market.

The reason for making the distinction between retail and wholesale clients was explained in the explanatory memorandum to the *Financial Services Reform Bill 2001* as follows:

> *"The FSR Bill draws a distinction between retail and wholesale clients. Generally, the consumer protection provisions will apply only to retail clients, as it is recognised that wholesale clients do not require the same level of protection, as they are better informed and better able to assess the risks involved in financial transactions."*

Increasingly it is being seen that the premise on which the distinction has been made is flawed and the reasons for this are clear: there are four general tests that determine whether a person is a "wholesale client" and only one of these takes into account whether a person is an experienced investor or "better able to assess the risks involved in financial transactions". For example, under one test, if $500,000 or more is invested in a financial product, then the investor is deemed to be a wholesale client and is therefore not provided the same statutory protections as retail clients.

Misconception about duties owed to wholesale clients

Whilst the distinction has resulted in inexperienced investors accessing complex financial products as wholesale clients, it appears to also have led to a misconception that wholesale clients are not owed the same duties as retail clients. It is true that there are a number of statutory protections that do not apply to wholesale clients, for example, they do not need to be given a product disclosure statement or a financial services guide. However, they are owed the same fiduciary duties by their advisers as retail clients and two recent decisions of the Federal Court have emphasised this proposition.

The Lehmann Brothers case

In *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)*, three municipal councils were sold financial products called Synthetic Collateralised Debt Obligations (SCDOs) by Grange Securities Limited (Grange). Grange represented to the councils that the SCDOs were conservative, liquid investments which met the councils' investment criteria.

After the GFC commenced, many of the SCDOs held by the councils either significantly reduced in value or became worthless. The councils alleged that Grange had engaged in conduct that was misleading and deceptive in relation to the sale of the SCDOs. The councils also alleged that Grange had breached fiduciary duties owed to them as investment advisors.

The court ruled that Grange was negligent in advising the councils to make such investments in SCDOs, had engaged in misleading and deceptive conduct and was in breach of its fiduciary duties as a financial advisor because there was a conflict between its duty to give sound financial advice or make sound investment decisions and its own interest in earning large fees or profits from the sale of SCDOs, which it did not disclose to the councils. The court held that Grange was liable to compensate the councils for their losses incurred as a result of their investments in SCDOs.

S&P and ABN Amro

Bathurst Regional Council v Local Government Financial Services Pty Ltd involved claims arising from the rating, sale and purchase of structured financial products known as a Constant Proportion Debt Obligations (CPDOs).

ABN Amro Bank NV (ABN Amro) was the product manufacturer of CPDOs, which were complex and highly leveraged credit derivatives. ABN Amro engaged Standard and Poor's (S&P) to rate the CPDOs. The CPDOs were rated as AAA. In engaging S&P to rate the CPDO, ABN Amro influenced S&P to adopt ABN Amro's model inputs as the basis for the rating rather than S&P conducting its own analysis.

An entity called Local Government Financial Services (LGFS), which provided financial advice to councils in NSW, purchased CPDOs and onsold them to various councils on the basis of S&P's AAA rating.

The court held that:

- S&P's AAA rating of the CPDOs was misleading and deceptive and that ABN Amro was knowingly concerned in S&P's contraventions of the various statutory provisions;
- ABN Amro had itself engaged in conduct that was misleading and deceptive;

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- LGFS had itself engaged in misleading and deceptive conduct and in one respect published information false in material particulars and otherwise made negligent misrepresentations to the councils about the CPDOs; and
- LGFS had breached its Australian financial services licence in advising the councils about, and dealing in, CPDOs when it was not authorised to give advice or deal in derivatives.

Implications for fund managers and advisors

The two cases emphasise the importance of ensuring that you comply with your fiduciary obligations to wholesale clients, particularly in circumstances where you stand to profit from the investment decisions they make based on your recommendations.

There have not been any further announcements from Treasury relating to the proposed changes to the retail and wholesale client distinction, but one would expect that the requirements for wholesale clients will be extended to ensure that wealthy inexperienced investors (or unsophisticated sophisticated clients) are no longer able to access complex products like CPDOs and SCDOs.

High Court rules against contracting out of scheme members' statutory rights

In *Westfield Management Limited v AMP Capital Property Nominees Limited [2012] HCA 54* the High Court has said agreements which seek to deprive members of registered managed investment schemes of certain statutory protections will be unenforceable.

UniSuper and Westfield JV

The case concerned the KSC Trust (**Trust**), a registered managed investment scheme which was established to acquire the Karrinyup Shopping Centre in Perth. The shopping centre is the Trust's primary asset.

The Trust is a joint venture between AMP Capital Property Nominees Limited as nominee for UniSuper Limited (**UniSuper**), which holds two-thirds of the units, and Westfield Management Limited (**Westfield**), which holds the remaining one-third. AMP Capital Investors Limited (**AMP**) is the responsible entity of the Trust.

A history of disputes

Westfield and UniSuper appear to have been at loggerheads over the operation of the Trust for some time. For example, in 2010 Westfield brought a separate action in New South Wales against AMP, UniSuper and David Jones Limited alleging that AMP failed to keep Westfield informed about its negotiations with David Jones and deliberately entered into agreements for lease with little or no prior notice. Westfield also disputed the validity of two resolutions of the unitholders of the Trust pursuant to which the entering of the lease agreements was approved.

Notice of meeting to terminate the trust

In the matter before the High Court, the joint venture agreement stated that the responsible entity (AMP) was prohibited from selling the shopping centre without the written consent of the unitholders.

At the request of UniSuper, AMP issued a notice of meeting of the unitholders of the Trust to consider a proposed extraordinary resolution directing the responsible entity to wind up the scheme. Section 601NB of the *Corporations Act 2001* (Cth) (**Corporations Act**) grants members the right to take action to call such a meeting.

UniSuper's two-third unitholding would allow it to carry the resolution alone (50 percent of all members entitled to vote was required). The effect of the winding up would be that the trust property, the Karrinyup Shopping Centre, would be sold without Westfield's consent.

Westfield opposed the resolution and obtained an injunction from the Supreme Court of New South Wales preventing UniSuper from voting in favour of it without the prior consent of Westfield. UniSuper appealed this decision to the NSW Court of Appeal and the injunction was set aside.

Westfield appealed by special leave to the High Court. Westfield argued that the joint venture agreement precluded a unilateral winding up of the scheme in accordance with section 601NB.

The decision: you cannot contract out of statutory rights

Having dismissed the appeal on the grounds of construction of the joint venture agreement, it was not necessary for the High Court to consider whether the statutory rights given to members by the Corporations Act to call a meeting of members to wind up a scheme could be bargained away. However, as both the primary judge and the Court of Appeal found that a provision in the joint venture agreement was not unenforceable in light of section 601NB, the High Court felt it necessary to comment on this point.

The High Court noted that contractual arrangements that defeat or circumvent a statutory purpose or policy according to which statutory rights are conferred in the public interest, rather than for individual benefit, will not be enforced and will be treated by the courts as ineffective or void.

Section 601NB allows a member to put the matter of termination of a scheme to a vote of members at any time during the life of the scheme. The right is clearly beneficial to individual scheme members. However, the High Court also found that the evident intention to the legislature is that it is in the public interest that scheme members be provided this right. That is, you cannot contract out of it.

Consequences for those investing in funds

- Review any agreements relating to interests in registered schemes to which you are a party and determine if any of the provisions seek to contract out of a statutory right. These provisions are likely to be unenforceable. Consider whether the agreement can operate effectively without these provisions, and if not, seek to get it varied.
- If you are intending to co-invest in a fund with other entities, then consider whether the fund needs to be registered (or whether you should invest in a registered fund if you want some control over the disposal of its assets). Unregistered funds provide less statutory protection for their members and can be much more flexible in how they operate than registered schemes. It is likely that the Trust was registered even though it only had two wholesale investors because of the pre-2007 ban on registered schemes investing in unregistered schemes or because UniSuper's investment criteria may have precluded investments in unregistered schemes.
- Other statutory rights of members of registered managed investments schemes that cannot be waived are likely to include:
    - Rights requiring member approval for related party transactions.
    - Rights of scheme members to make an application to the court to wind up a scheme.
    - Rights of members with at least 5% of the votes to request a meeting of the scheme's members to consider and vote on a proposed special or extraordinary resolution.

Thomsons Lawyers can assist you structure and document joint ventures and co-investments in registered schemes and undertake due diligence on scheme investments.

Raising capital for funds under the new Significant Investor visa

The new Significant Investor visa provides a great opportunity for Australian fund managers to promote their managed investment products to high net worth individuals who wish to migrate to Australia.

The new visa rules introduce a simplified pathway to permanent residence for migrant investors who invest $5 million into "complying investments" in Australia for a minimum period of four years.

First movers

Although the concept of the Significant Investor visa was first announced in May 2012, the regulations which introduced the new visa were only registered on 23 November 2012, a day before they commenced.

Despite the rules only being registered just prior to commencement, some fund managers have already taken the opportunity to create funds intended to comply with the new rules. For example, Moelis & Co has established the Moelis Australia Property Visa Fund which is seeking to raise $500 million from migrants to be invested in Australian real estate assets and NSW state government bonds. The Australia Capital Investment Fund has also been established to take advantage of the new rules and it is being reported that JBWere, who has been appointed as asset consultant to that fund, has already attracted $500 million investment from 100 Chinese investors for that fund.

What is a "complying investment"?

The $5 million aggregate investment can be invested solely in, or divided amongst, the following investment products:

- an investment in a government bond of the commonwealth, a state or territory;
- a direct investment in an Australian proprietary company that meets the following requirements:
    - the company is not listed on an Australian stock exchange;
    - the company has not been established wholly or substantially to comply with the new visa rules; and
    - the investment is an "ownership interest" in the company.
- an investment in a "managed fund" (directly or through an investor-directed portfolio service) where the fund only makes investments in assets which fall into categories determined by the Minister for Immigration and Citizenship (set out below).

Which funds qualify as "managed funds" under the new rules?

If you are considering establishing a fund or investment vehicle to source investments from migrants who wish to apply for permanent residency using the Significant Investor visa, then you should address the following key questions (and consider our answers):

Does my fund need to be registered to comply?

No. The rules require that the investment is an acquisition of interests in a "managed investment scheme" (as that term is defined in the Corporations Act 2001 (Cth) (**Corporations Act**)). This means the fund can be a registered or unregistered (e.g., wholesale) managed investment scheme.

Does the trustee need to hold an Australian financial services (AFS) licence?

No. The rules do not expressly require that the trustee holds an AFS licence: they state that the issue of an interest in the fund is "covered by" an AFS licence.

Can units in the fund be listed (now or in the future)?

No. The interests in the fund must not be able to be traded on a financial market and no representation can be made to any member of the scheme that the interests will be able to be traded on a financial market.

What can the fund invest in?

There are a number of investment restrictions imposed by the Commonwealth government which are set out below. In addition, the grant of a Significant Investor visa is generally a two-step process: an applicant must be nominated by a state or territory government agency before their application will be considered by the Commonwealth Department of Immigration and Citizenship (**DIAC**). This gives the states and territories the opportunity to impose their own investment requirements on a fund seeking to comply with the new rules. For example, the NSW state government requires applicants to invest at least 30 percent of the required $5 million investment into NSW Waratah Bonds in order to be nominated.

At the time this article was prepared, the state and territory requirements can be summarised as follows:

State	Relevant Authority	Requirements
NSW	Business Migration and Industry Skills, Department of Trade and Investment.	• Applicant must invest at least 30 percent of the $5 million in NSW Waratah Bonds.
QLD	Skilled and Business Migration Unit, Department of Education, Training and Employment.	• Applicants will be considered on a case by case basis with preference given to applicants with investments that have a direct economic benefit to Queensland. • Applicants should have a genuine and realistic commitment to reside in Queensland. • Complying investments can include Queensland Treasury Corporation's Queensland Bonds which are used for significant infrastructure projects in Queensland. • If the investment is in a new or existing business, the business will be required to be registered and operating in Queensland.
SA	Immigration South Australia.	• Applicants must have a commitment to conduct bi-annual surveys issued by Immigration SA during the provisional visa term. • Applicants must invest a minimum of $3 million in a South Australian ASIC registered proprietary business for a minimum of 2 of the 4 year provisional visa period.
TAS	Department of Economic Development, Tourism and the Arts.	• Applicants must participate in regular surveys conducted by the Tasmanian Government to track investment and success of visa programs. • Applicants must consult the Tasmanian Government prior to switching between complying investments. • Applicants may hold complying investments in any proportion they choose. Complying investments include Tasmanian State Government Bonds issued by the Tasmanian Public Finance Corporation (TASCORP), Australian Securities and Investment Commission (ASIC) regulated managed funds and direct investments made into Tasmanian companies not listed on the Australian stock exchange.

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State	Relevant Authority	Requirements
WA	Small Business Development Corporation, Business Migration Centre.	• Applicants must have an additional $50,000 available for domestic and/or settlement purposes. • Applicants may hold complying investments in any proportion they choose. Complying investments can include Western Australian State Government bonds. • Applicants will be considered on a case by case basis with the contribution to the Western Australian economy being the prime factor considered for approval.
ACT	Migration and Information Services, Chief Minister's Department.	• Criteria are currently under review by the relevant State authority.
VIC	Skilled and Business Migration Program, Department of Business and Innovation.	• Criteria are currently under review by the relevant State authority.
NT	Skilled Migration, Department of Business and Employment.	• No statement regarding criteria has been issued.

Can I promote my product outside Australia?

If you intend to promote your investment products overseas, then you will need to consider the laws applying in the jurisdiction in which your offer is being made. Otherwise, you must ensure that any offer you make is received by potential investors in Australia.

Fund investment restrictions

In addition to meeting the requirements above, the fund must only make investments in the following classes of assets determined by the Minister:

- infrastructure projects in Australia;
- cash held by Australian deposit taking institutions;
- bonds issued by the commonwealth or a state or territory government;
- bonds, equity, hybrids or other corporate debt in companies and trusts listed on an Australian stock exchange;
- bonds or term deposits issued by Australian financial institutions;
- real estate in Australia;
- Australian agribusiness; and
- other ASIC regulated managed funds that invest in the above list of investments.

Fund manager declaration

Visa applicants must submit a declaration, which has been completed by the relevant fund manager, to the Minister to verify that the ASIC regulated managed fund is a complying investment. The declaration required is that the investments made by the managed fund are limited to the aforementioned categories of investments in Australia specified by the Minister.

Investments in shares in Australian proprietary companies

To be complying, a direct investment into an Australian proprietary company must satisfy the following criteria:

- the company must genuinely operate a "qualifying business" in Australia;
- the applicant must obtain an "ownership interest" in the company;
- the company must be registered with ASIC; and
- the business must have an Australian Business Number.

The rules define a "qualifying business" as an enterprise that is operated for the purpose of making profit through the provision of goods, services or goods and services (other than the provision of rental property) to the public and is not operated primarily or substantially for the purpose of speculative or passive investment.

A business will not be a qualifying business if, for example, the main activity of the business is holding share portfolios, interest bearing deposits or rental property, involves currency speculation, or is property speculation (i.e., buying and selling real estate) rather than property development (i.e., building or renovating property). "Ownership interest" means an interest in the business as a shareholder in a company that carries on the business, a partner in a partnership that carries on the business or the sole proprietor of the business. This includes an interest held indirectly through one or more interposed companies, partnerships or trusts.

Direct investments in property

Direct investment in property, or direct investment in an Australian proprietary company which operates with the purpose of providing rental property or property speculation, does not constitute a complying investment.

However, investments in ASIC regulated managed funds which invest in real estate in Australia are complying investments.

Gains and losses and switching investments

The rules require visa holders to hold the complying investment for the whole of the investment period. However, visa holders have the ability to switch between investments, provided that the visa holder makes a new investment of at least the value of the withdrawn money or the cancelled investment, the new investment is a complying investment and the reinvestment is made within 30 days of withdrawing the funds from the original complying investment.

If the balance of the complying investment fluctuates below $5 million, the visa holder is not required to provide additional funds to maintain the threshold value so long as they do not withdraw their complying investment. Conversely, if the balance increases, the visa holder cannot withdraw the increased value.

Implications for migrants

The Significant Investor visa also provides valuable opportunities for prospective business migrants as it provides several concessions which are not available for other types of visas. For example, there is no upper age limit, there is no need to satisfy the innovation points test, there is no English language threshold requirement and the residency requirement is reduced to 160 days cumulatively over the initial four year visa period. Business migrants may include family members such as their partner (spouse or de facto of at least 12 months), their partner's dependent children, and other dependent relatives in the visa application.

Opportunities for fund managers to attract new capital

It has been estimated by DIAC that it will grant 700 visas annually with $3.5 billion potentially flowing to complying investments. If these estimates are accurate, then there is a significant opportunity for fund managers to source capital from prospective business migrants.

If you are considering establishing a fund to attract migrant investors, then you need to ensure the fund meets the relevant requirements under the rules. Thomsons Lawyers are experienced in establishing investment vehicles and advising on AFS licensing requirements, and can assist you develop an investment product which will comply with the Significant Investor visa requirements.

Demergers made easier by recent court decision

Demergers often occur by way of an in specie distribution of assets or shares or units in an investment vehicle. A recent Federal Court decision has confirmed that trustees can rely on their 'natural person' powers to effect such demergers without specific approval of the trust beneficiaries.

Facts

Wellington Capital Limited (**Wellington**) is the responsible entity of the Premium Income Fund (**PIF**). 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.

Decision

The PIF constitution contains very broad trustee powers. 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) to distribute "*any of the company's property among the members, in kind or otherwise*".

In finding for Wellington, the single judge agreed with Wellington's arguments relating to the construction of the constitution. The judge said 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, it 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. The judge said that unit holders must therefore accept the exercise of those powers.

Implications for REs

This decision confirms that broad trustee powers contained in constitutions provide a responsible entity with maximum flexibility in how it can deal with scheme assets, including by way of demerger or spin out. Even though a constitution may not include an express power to perform a particular function such as a demerger or spin out of assets, if a general power to deal with the assets exists, then the responsible entity may act in accordance with that general power. Responsible entities can also exercise general powers with the knowledge that unit holders must accept the exercise of that power, assuming it is not otherwise in breach of the constitution. The exercise of any power by a responsible entity is, of course, not unfettered: trustees must always act in good faith and in the interests of members, for example.

Relying on general powers to perform significant transactions is also not without its risks - legal and otherwise. Since the GFC, responsible entities have been criticised for relying on broadly drafted trustee powers in scheme constitutions to undertake transactions which investors have perceived as *ultra vires*. Generally, these criticisms relate to acquiring assets beyond investment mandates published in disclosure documents or investing in related funds with risk profiles that are inconsistent with the principal fund.

If you are in doubt about exercising a power under a constitution, then it is best to get a direction from a court or a mandate from investors, assuming you can do this within your transaction timeframe. Otherwise, you are at risk of action from your investors and the regulator, and then ultimately the fate of your transaction rests with the court.

Why demerge?

In its release to the NSX, Wellington cited reasons such as accessing particular experience of entities related to ARL to manage the assets as the basis for conducting the spin out. However, there are a number of other reasons why a trust might contemplate a demerger or spin out of assets including to:

- remove underperforming investments from the trust's portfolio;
- quarantine liability;
- remove conflicts of interest;
- generate cash through the sale of the demerged entity's shares; and
- de-leverage.

If you are looking to unlock value in a trust, then you should consider a demerger or spin out. The key issues you need to consider before undertaking such a transaction are:

- whether the transaction is in the best interests of investors;
- whether your constituent documents permit the transaction to occur;
- whether you should seek court or member approval for the transaction; and
- the taxation implications for the trust and its members.

Thomsons regularly advises on corporate restructures, demergers and spin outs. Recent examples include:

- Auzex Resources Limited's demerger of its mineral exploration asset portfolio in January 2012
- McPherson's Limited's demerger of MPG Printing Limited in March 2012

Sector developments[1]

FOFA

ASIC consults on code approval under FOFA and confirms facilitative approach to FOFA introduction

ASIC has released a consultation paper on its approach to code approval and relief powers under the Future of Financial Advice (FOFA) reforms. ASIC also confirmed

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

that it will be taking a facilitative approach to the implementation of FOFA.

Codes Approval

ASIC has existing power under the Corporations Act to approve codes of conduct, with Regulatory Guide 183 *Approval of financial services sector codes of conduct* (RG 183) setting out ASIC's minimum expectations in this area.

Consultation Paper 191 *Future of Financial Advice: Approval of codes of conduct for exemption from opt-in requirement* (CP 191) sought feedback on how RG 183 should be amended for FOFA.

ASIC will consider applications for approval of a FOFA code once final policy is published in RG 183. The code approval process will be careful and rigorous and it will take months rather than weeks for ASIC to assess a code. ASIC notes that unless a licensee opts in to the FOFA regime before 1 July 2013, the earliest date an adviser would need to comply with the opt-in requirement, or join an approved code, is 1 July 2015.

Submissions to CP 191 closed on 3 December 2012.

FOFA Implementation

ASIC has reaffirmed that it will take a facilitative approach during the first 12 months of the FOFA reforms from 1 July 2013.

ASIC will adopt a measured approach where inadvertent breaches arise or systems changes are underway, provided industry participants are making reasonable efforts to comply.

ASIC key FOFA guidance released

ASIC has released final guidance for two aspects of the Future of Financial Advice (FOFA) reforms – the best interests duty and scaled advice - and provided an update on its proposed guidance for the FOFA conflicted remuneration provisions.

Best interests duty

ASIC's final guidance on the best interests duty covers:

- acting in the best interests of the client;
- satisfying the 'safe harbour' for the best interests duty ;
- providing appropriate personal advice; and
- prioritising the interests of the client.

The guidance is in an update to Regulatory Guide 175 *Licensing: Financial product advisers – conduct and disclosure.*

Scaled advice

ASIC has provided specific guidance and examples about giving scaled advice while complying with the best interests duty.

It includes worked examples of scaled advice by banks, general insurers, superannuation funds, financial planners and stockbrokers.

The guidance is in Regulatory Guide 244 *Giving information, general advice and scaled advice.*

Update on CP 189 – Conflicted Remuneration and Employee Remuneration

In September 2012, ASIC proposed guidance on the conflicted remuneration ban in Consultation Paper 189 Future of *Financial Advice: Conflicted remuneration* (CP 189).

CP 189 outlined when ASIC is more likely to scrutinise a performance benefit as part of employee remuneration for potential conflict. This included an indication of what percentage of performance benefits that relates to sales volumes may trigger closer scrutiny by ASIC. The aim of the proposal was to give industry more certainty about when ASIC may scrutinise performance benefits.

Submissions to CP 189 have raised difficulties with the identification of a single indicative percentage and have not supported ASIC providing indicative thresholds for when we are more likely to scrutinise a benefit. In light of this feedback, ASIC proposes to remove indicative thresholds from its final guidance.

ASIC will release final guidance on conflicted remuneration in February 2013.

Managed investment schemes

ASIC releases report on risk management in the funds management sector

ASIC has released report Report 298 *Adequacy of risk management systems of responsible entities* (REP 298).

In the responsible entities reviewed, ASIC found that the sophistication of risk management systems varied greatly. While they generally had adequate risk management systems adapted to the nature, scale and complexity of their financial services businesses, ASIC observed that improvements could be made, especially for those responsible entities that are not part of an Australian Prudential Regulation Authority (APRA)-regulated group.

In addition, ASIC found that smaller responsible entities tend to face:

- key person risk where the loss of one or two people, either temporarily or permanently, may produce a major impact on the operations of the responsible entity and the performance of its funds; and
- the risk of overreliance on external compliance and risk management consultants without necessarily having the skills and resources to independently assess the quality of their services.

ASIC expects to consult on developing good practice guidance on risk management systems for responsible entities in 2013.

ASIC consultation on the constitutions of registered managed investment schemes

ASIC has released a consultation paper outlining proposals to update the guidance relating to the content requirements of constitutions of registered managed investment schemes.

Consultation Paper 188 *Managed investments: Constitutions – Updates to RG 134* (CP 188) contains proposals about ASIC's views on the requirements in s601GA and s601GB of the Corporations Act 2001, and how it will apply them in deciding to register a managed investment scheme.

ASIC's proposed guidance covers the following areas in relation to a registered managed investment scheme:

- implementation;
- the consideration to acquire an interest in the scheme;
- powers of the responsible entity of the scheme;
- complaints handling for retail clients and wholesale clients;
- winding up the scheme;
- the payment of fees to a responsible entity and its rights of indemnity from scheme property;
- withdrawal rights of members of the scheme;
- the use of extrinsic material to the constitution; and
- legal enforceability of the constitution.

Modifications to the new financial requirements for responsible entities

ASIC has issued a class order refining the financial requirements for responsible entities (REs) which were released in November 2011.

A new ASIC Regulatory Guide 166 was also issued which incorporates the new requirements.

ASIC consults on revised financial requirements for custodians and providers of custodial and depository services

ASIC has released a consultation paper on proposed changes to the financial requirements for providers of custodial or depository services. The paper also sets out requirements that apply to responsible entities of registered managed investment schemes and platform operators that hold scheme property or other property and assets.

Consultation Paper 194: *Financial requirements for custodial or depository service providers* (CP 194) seeks feedback about:

- doubling the net tangible assets (NTA) requirement for custodians (other than incidental providers) from $5 million to the greater of $10 million or 10 per cent of average revenue;
- increasing the NTA requirement for responsible entities holding scheme property or assets and investor-directed portfolio services (IDPS) operators responsible for holding IDPS property or assets in certain circumstances from $5 million to the greater of $10 million or 10 per cent of average revenue;
- defining the term 'incidental custodial or depository services';
- introducing an NTA requirement for incidental custodial or depository service providers equal to the greater of $150,000 or 10 per cent of average revenue;
- requiring providers to produce 12-month cash flow projections; and
- specifying liquidity requirements for custodial and depository service providers.

ASIC is seeking feedback on CP 194 by 14 January 2013.

ASIC extends shorter PDS regime relief

ASIC has extended interim class order relief from the shorter PDS regime for multi-funds, superannuation platforms and hedge funds.

ASIC has extended the relief pending a future Government decision on the application of the shorter PDS regime to superannuation platforms, multi-funds and hedge funds.

From 22 June 2013 hedge funds must prepare and give a full PDS. Extending the transitional period for hedge funds will align with the commencement of new disclosure obligations for hedge funds under ASIC Regulatory Guide 240 *Hedge funds: Improving disclosure* (RG 240). The obligation to disclose against the benchmarks and disclosure principles under RG 240 starts on 22 June 2013.

Financial advice

Legislative amendments relating to the use of the expressions 'financial planner' and 'financial adviser'

The Federal Government has released an exposure draft of legislative amendments to restrict the use of the terms 'financial adviser' and 'financial planner'.

A number of terms are defined and restricted in the Corporations Act. For example, use of the terms 'independent', 'impartial' and 'unbiased' is restricted, as is use of terminology such as 'stockbroker', 'futures broker' and 'insurance broker'. Restricting terms in this way is intended to signal to consumers certain information about the person using them – for example, that the person does not accept commissions or is authorised to act as a stockbroker. The addition of 'financial adviser' and 'financial planner' to these terms is intended to improve outcomes for consumers of financial advice services, by empowering consumers of financial services to identify genuine providers of financial product advice.

Submissions on the draft regulations closed on 21 December 2012

Replacement of the accountant's exemption

The Federal Government has released draft regulations that will replace the accountant's exemption with a new form of limited licence.

The draft regulations include:

- authority for licence holders to give "class of product advice" on basic deposit products, general and life insurance, securities, and simple managed investment schemes, in addition to being able to advise on self-managed superannuation funds and superannuation generally;
- streamlined experience requirements for accountants who hold a practicing certificate issued by one of the professional accounting bodies (the Institute of Chartered Accountants in Australia, CPA Australia Ltd and the Institute of Public Accountants); and
- an exemption from the audit requirements for limited licence holders who do not handle client money and instead submit an annual compliance certificate.

Submissions on the draft regulations close on 21 December 2012

Derivatives and CFD providers

ASIC calls for improved compliance in CFD and margin FX client money handling practices

ASIC has issued a warning to the contracts for difference (CFD) and margin foreign exchange (FX) sectors following the release of a report highlighting weaknesses in client money handling practices.

Report 316 *Review of client money handling practices in the CFD and margin FX sector* (REP 316), follows a risk-based surveillance of 40 issuers of OTC CFDs and margin FX contracts.

The review focused on issuers' client money handling and reconciliation practices. It also gathered information about the amount of client money issuers hold and how they use this money. The 40 issuers ASIC reviewed represent the overwhelming majority of market share in the sector.

ASIC identified a number of contraventions of client money rules as part of its review, including:

- 18 issuers (45%) failed to properly designate client accounts as trust accounts; and
- 11 issuers (28%) failed to pay client money into a compliant account by the next business day following receipt.

In addition, ASIC's review identified further weaknesses, including:

- six issuers (15%) did not perform client money reconciliations on a daily basis;
- five issuers (13%) had inadequate segregation of duties in their back office; and
- 19 issuers (48%) had no formal escalation process for resolving variances in the reconciliation.

Hedge Funds

ASIC guidance on hedge fund disclosure

ASIC has released Regulatory Guide 240 *Hedge funds: Improving disclosure* (RG 240) which provides guidance on new disclosure benchmarks and principles for hedge funds to improve investor awareness of the risks associated with these products.

RG 240 requires hedge fund managers to disclose against two benchmarks and nine disclosure principles on an 'if not, why not' basis.

'Hedge funds' are defined as managed investment schemes which exhibit at least two out of five characteristics: complex investment strategy or structure, use of leverage, use of derivatives, use of short selling and charging a performance fee. Where a hedge fund has invested 35% or more of its assets in an underlying hedge fund or similar investment vehicle, the disclosure principles and benchmarks should be taken to apply to each such 'significant underlying fund'.

Responsible entities of hedge funds will need to disclose against the benchmarks and apply the disclosure principles in any PDS dated on or after 22 June 2013.

ASIC extends shorter PDS regime relief

ASIC has extended the transition period for hedge fund managers who have issued PDSs under the shorter PDS regime to 22 June 2013. From 22 June 2013, hedge funds must prepare and give a full PDS.

Property funds

ASIC releases updated investor guide for unlisted property schemes

ASIC has released an updated investor guide to improve awareness of the risks associated when investing in unlisted property schemes.

'Investing in unlisted property schemes' is an update of ASIC's previous investor guide, and follows the release of updated regulatory guidance for unlisted property schemes in March 2012.

The updated guide is intended to help investors:

- find out about the investment product itself;
- understand the features and risks and ask the right questions;
- use the benchmark and disclosure principle information in the PDS and other disclosure documents to assess the risks; and
- decide if the investment suits investors' financial goals and objectives.

Debenture issuers

ASIC Chairman, Greg Medcraft, has announced an internal taskforce to look at the failure of Victorian debenture issuer Banksia Securities Limited and regulation of the wider Australian unlisted debenture sector. The taskforce will make recommendations to Treasury.

ASIC's recent activity in this sector more broadly has included undertaking general market reviews into the Australia unlisted debenture market and ASIC has conducted risk based surveillances on a small number of debenture issuers.

ASIC's historical work in the debenture sector reflects the fact that a disclosure regime is in place for debentures, coupled with the requirement that a trustee is in place to monitor the issuer and seek to protect the interests of debenture holders.

Tax

Trust tax reform

On 21 November 2011, the Assistant Treasurer released an initial consultation paper, *Modernising the taxation of trust income — options for reform*, which outlined three possible models for taxing trust income. The consultation highlighted, in particular, a desire for more information about two of the proposed models — the 'trustee assessment and deduction' model, and the 'proportionate within class' model.

In October, the Assistant Treasurer released a further policy options paper which responds to the consultations and further articulates the design of those two models, which have been renamed the 'economic benefits model' and the 'proportionate assessment model' to better reflect their objectives.

Submissions on the options paper closed on Wednesday 5 December 2012.

Treasurer announces formal discussion with the US on the Foreign Account Tax Compliance Act

The federal Treasurer has announced that Australia has commenced formal discussions for an intergovernmental agreement with the United States to minimise the impact for Australians of the United States' Foreign Account Tax Compliance Act (FATCA) in Australia.

FATCA was enacted by the United States Congress in March 2010 as part of US efforts to improve compliance with US tax laws. FATCA imposes certain due diligence and reporting obligations on foreign (non-US) financial institutions including Australian institutions.

A key objective of the intergovernmental agreement the Australian Government is negotiating with the US Administration is to facilitate Australian compliance with FATCA in a way that reduces its overall burden on Australian business.

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

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