10. The scheme operator

Introduction

10.1 The quality of a scheme operator and the way in which it conducts the affairs of a scheme will have a strong bearing on the scheme's success or failure. This chapter deals with the duties scheme operators and their officers should owe to scheme investors, the financial and structural controls on scheme operators and the licensing of operators.

Scheme operators to be companies

10.2 Under the existing law, only a public corporation may issue prescribed interests.[1] DP 53 suggested that there was no need for this requirement.[2] A number of submissions disagreed.[3] It was said that there can be problems with unincorporated fund managers if different individuals are involved throughout the life of the scheme. By contrast, an incorporated body remains even with a change of directors or other managerial personnel. Also, requiring managers to be incorporated would allow the regulator to take advantage of existing reporting mechanisms.[4] The Review has concluded that, given the difficulties of dealing with unincorporated groups because of changes in personnel, the ASC will be better able to supervise operators of collective investment schemes if they are corporations. Accordingly the Review **recommends** that only companies incorporated under the Corporations Law may apply for a scheme operators licence.[5]

Duties of scheme operators and their officers

Several sources of obligations

10.3 The operator of a collective investment scheme will be subject to obligations from three sources — the Corporations Law, the general law and the constitution of the scheme. Statutory obligations should be clearly expressed and be of general application. This will help to focus a scheme operator's attention on its responsibilities.

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1. Corporations Law s 1064.
2. Para 4.16.
3. eg IFA *Submission* 30 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; Attorney-General's Department *Submission* 21 December 1992.
4. Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992. The Review recommends that scheme operators should have to lodge annual audited accounts with the ASC and make them available upon request to investors: see para 5.28.
5. The Review recommends that all scheme operators be licensed: see para 10.35. If it is decided in the future that companies registered in New Zealand ought to be allowed to establish and market collective investment schemes in Australia, appropriate modification to the law may be required.

Imposing general obligations by statute

10.4 ***To ensure an appropriate relationship between the scheme operator and investors.*** Collective investment schemes may take various legal forms.[6] In all cases, however, the operator and its directors will be in a fiduciary relationship with investors. The basic fiduciary relationship between operators and investors and the fundamental obligations of operators should be common to all schemes and incapable of variation through scheme constitutions. This can be done most effectively by imposing a minimum common set of duties through the Corporations Law.

10.5 ***DP 53 proposal and submissions.*** DP 53 suggested a set of minimum statutory obligations for all operators and their directors.[7] Many submissions supported the proposal.[8] Others did not.

> [W]e believe that the Discussion Paper does not consider the effect of statutory intervention on a constantly developing body of equitable doctrine. The enactment of a 'statutory fiduciary duty' creates an opportunity for confusion with the analogous obligation imposed by equity and may inhibit the development of the equitable doctrine. In fact it has created some of the problems which the industry presently faces . . . [T]he benefit (if any) of creating a statutory duty where the relevant obligation is already well established at general law is unclear.[9]

There was concern too that it may not be possible to draft these duties with sufficient clarity to be useful.[10]

10.6 ***Recommendation.*** It should be made abundantly clear that responsibility for a collective investment scheme lies with the operator of the scheme. To assist in highlighting that responsibility the Corporations Law should set out duties common to all operators of collective investment schemes, regardless of their legal structure. This will

- lead to a better understanding and awareness of the obligations of operators
- enhance the ability of the regulator to enforce them
- eliminate the possibility that these obligations may be eroded or avoided by the terms of the scheme's constitution.

The Review acknowledges the concerns expressed in submissions about including in legislation duties which presently exist only at general law. On balance, the Review considers that the advantages outweigh the possible detriments. The Corporations Law already imposes some general fiduciary duties on directors and officers, which reflect or supplement duties imposed by the general law.[11] The Review **recommends** that the Corporations Law should state clearly a set of

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6. eg trusts, partnerships, limited partnerships, contractual arrangements.
7. Proposals 4.5, 4.7.
8. eg Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992.
9. Freehill Hollingdale & Page *Submission* 8 December 1992.
10. eg T Valentine *Submission* 5 November 1992.
11. eg requirements to act honestly (Corporations Law s 232(2)) and to exercise a reasonable degree of care and diligence: s 232(4). See also s 232(11).

obligations for operators and their officers which may not be modified or excluded by a scheme's constitution. It has already recommended in chapter 4 that the system of prescribed covenants be abolished and that obligations should be imposed on scheme operators directly by the law.[12] These obligations should be in addition to the duties scheme operators owe to investors at general law. The duties of officers of operators should be in addition to duties they owe to the company at general law or under the Corporations Law s 232.

Duties imposed on scheme operators

10.7 ***Duty to act honestly.*** The obligation to act honestly is fundamental.[13] It should apply to operators of all collective investment schemes, whatever the scheme's legal structure. The Review **recommends** that the Corporations Law should impose an obligation on the operator of a collective investment scheme to act honestly in respect of the scheme.[14]

10.8 ***Duty to act in the interests of investors.*** Investors in collective investment schemes rely heavily on the operator to act in their best interests. Nevertheless, there will often be a potential for conflict between their interests and those of the operator. This may arise over the fees and charges payable to the operator or the use of scheme property for dealings with parties related to the operator. DP 53 proposed that the law should impose on operators a duty to avoid conflicts of interest.[15] A number of submissions argued that this proposal was neither realistic nor desirable.[16] Conflicts of interest between scheme operators and investors are inevitable. The Review has concluded that the appropriate formulation of the test is that operators must prefer the interests of investors over their own interests where any conflicts arise.[17] The Review **recommends** that the Corporations Law should impose an obligation on the operator of a collective investment scheme to exercise its powers and perform its duties as operator in the best interests of investors rather than in its own, or anyone else's, interest, if that interest is not identical to the interests of the scheme investors. This duty should be complemented by specific rules for related party transactions.[18]

10.9 ***Expenses and charges not to be paid otherwise than in accordance with the scheme constitution.*** In consultations with the Review, trustees emphasised that they spend a considerable amount of time assessing whether claims by managers

12. See para 4.4.
13. The Corporations Law imposes on officers an obligation to act honestly in exercising the powers and discharging the duties of the office: s 232(2).
14. See ch 15 for discussion of the circumstances in which a breach of the obligations set out in this chapter will be attributed to the operator.
15. Proposal 4.7.
16. Freehill Hollingdale & Page *Submission* 8 December 1992; Arthur Robinson & Hedderwicks *Submission* 10 December 1992; IFA *Submission* 1 December 1992; MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
17. This reflects the fiduciary obligation which the general law imposes on persons in the position of the operator, eg, the general principle that no one who has a fiduciary duty to perform shall place himself or herself in such a position that his or her interest will, or even may, conflict with that duty and that, if interest and duty do conflict, interest must give way: RP Meagher QC & WMC Gummow *Jacobs' Law of Trusts in Australia* 5th ed 1986, 416.
18. See para 10.25, 10.26.

for reimbursement of expenses should be paid. It was suggested that many claims are made for unauthorised expenses. DP 53 proposed that operators of collective investment schemes should be subject to a duty not to make a profit from a collective investment scheme other than as provided for in the constituting document. Several submissions expressed concern about this proposal. For example, one was concerned that the payment of two sets of fees, for administration and funds management, in a master trust arrangement would constitute a breach of trust.[19] Another was concerned that investing a scheme's money in another scheme operated by the same operator would effectively be prohibited.[20] The Review no longer considers that a duty regarding expenses and charges needs to be stated expressly given other relevant duties, for instance, to observe the scheme's constitution and not to make improper use of its position. An alternative suggested to the Review was that scheme operators should be subject to a fixed fee instead of a management fee plus expenses. The Review does not consider that appropriate as various expenses that should be paid by the scheme may not be foreseeable when fixing the fee. Instead, the Review **recommends** that it should be an offence for an operator to make payments out of the scheme property on account of expenses or charges, either for itself or for anyone else, except in accordance with the scheme's constitution. A scheme's constitution should state the basis on which the scheme operator will be remunerated and clearly state the basis for payment of expenses. This information should be disclosed in the scheme prospectus.[21]

10.10 ***Costs of hiring an investment manager or investment adviser.*** A scheme operator's fee should reflect its responsibility for investing the assets of the scheme. DP 53 proposed that, if a scheme operator hires an investment manager to perform all or part of that function, the costs involved should be borne by the operator, not the scheme.[22] This was on the basis that the scheme will already have paid the operator a fee for managing the scheme. The proposal received widespread support.[23] The Review **recommends** that an operator should not be able to recover from scheme assets the cost of hiring an investment manager or an investment adviser.

10.11 ***Duty to keep scheme property separate from the operator's property.*** The principle that trust funds should always be kept separate from the assets of the trustee applies equally to collective investment schemes and traditional trusts. The Corporations Law presently requires that there be a separate trustee or representative to hold the scheme property on trust for the investors, unless title remains with investors. The same principle can be applied by requiring scheme operators to separate scheme assets from their own. The Review **recommends** that the Corporations Law should impose an obligation on operators of schemes in which the investors do not retain title to the scheme's assets, to keep the scheme's

19. Macquarie Investment Management Limited *Submission* 24 November 1992.
20. St George Funds Manager Limited *Submission* 18 December 1992.
21. See para 5.14. The scheme's Management Expense Ratio for the previous five years will also be required to be disclosed in the prospectus: see para 5.14.
22. Proposal 5.13.
23. eg IFA *Submission* 1 December 1992; ISC *Submission* 12 November 1992; JK Denyer *Submission* 3 November 1992; MLC Investments Limited *Submission* 17 December 1992; TCA *Submission* 17 December 1992.

assets separate from their own assets. This obligation will in most cases be satisfied by compliance with other, more specific, requirements, for example, the requirement that operators identify scheme assets in a way that clearly marks them as scheme assets.[24]

10.12 ***Duty to treat investors equally and fairly.*** The duty that a trustee has to act fairly when dealing with beneficiaries whose rights are dissimilar is well established. Approved deeds for prescribed interest schemes must include a covenant binding the trustee and the manager to treat the holders of interests of the same class equally and to treat the holders of interests of different classes fairly.[25] The Review **recommends** that this obligation should be imposed directly by the Corporations Law on operators of all collective investment schemes.

10.13 ***Not to make improper use of information or position.*** The Corporations Law imposes a direct obligation on a director of a company not to make improper use of information that he or she receives as a director, or of his or her position as a director, to gain an advantage for himself or herself or for anyone else, or to damage the company.[26] This duty is based on the principle that a director should not profit from his or her position in the company. Trust law imposes a similar duty on a trustee, for the benefit of the beneficiaries in the trust.[27] Given the fiduciary nature of the relationship between the operator and the investors in a collective investment scheme, the law should impose a similar obligation on the operator itself, for the benefit of the investors. The Review **recommends**, therefore, that the Corporations Law should provide that an operator must not make improper use of information that it gets as operator of a particular scheme, or of its position as operator, to gain an advantage for itself or for any other person or to cause detriment to the investors in the scheme. This obligation should extend to a company that was the operator of a scheme.

10.14 ***No statutory duty to observe the constitution of the scheme.*** The recommendations in this report are directed largely at reducing to an acceptable level the risk that an operator will not comply with the law or the constitution of its collective investment scheme. The operator, by establishing and marketing a scheme with a particular constitution, in effect promises investors that it will adhere to the constitution's requirements. DP 53 proposed that the Corporations Law should include an obligation to observe the constituting document of the scheme.[28] The Review no longer considers, however, that it is appropriate to place this obligation in statute. Breach of the scheme constitution should not be an offence because it is inappropriate to have the ASC prosecuting breaches of a private agreement. Including in the law the obligation to observe the scheme constitution

24. See para 9.15.
25. Corporations Regulations reg 7.12.15(1)(f)(ii).
26. Corporations Law s 232(5), (6).
27. A trustee must not abuse its position by making it a means of profit or benefit to itself or any third party: *Stuart v Kingston* (1924) 34 CLR 394, 401. A trustee must account for benefits or gains obtained in circumstances where there was an actual or significant possibility of a conflict between personal interest and fiduciary duty and must account for any benefit or gain obtained or received by reason of or by use of its fiduciary position or of opportunity or knowledge resulting from it: RP Meagher QC & WMC Gummow *Jacobs' Law of Trusts in Australia* 5th ed 1986, 421.
28. Proposal 4.7.

is not necessary to enable investors to enforce the constitution. Investors will be able to enforce the constitution at general law. The ASC will also be able to enforce a scheme constitution either by representative action[29] or by seeking a compliance order from the court.[30] The Review does not recommend, therefore, that the Corporations Law should expressly impose an obligation on a scheme operator to adhere to the scheme's constitution.

Duties imposed on officers of operators[31]

10.15 ***Proposal and submissions.*** The Review has recommended that all scheme operators should be companies incorporated under the Corporations Law.[32] The directors of an operator will, therefore, owe duties to the company.[33] DP 53 proposed that the law should require each director of an incorporated operator to owe to scheme investors the same general duties that the Review proposed should be owed by the operator itself.[34] This proposal was designed to overcome a gap in the existing regulatory framework for collective investment schemes.

> There is nothing directly corresponding to the criminal and civil sanctions imposed on directors of corporate enterprises by way of statutory duties as is found, for instance, in Part 3.2 of the Law. Obviously the directors of the management company are subject to these provisions, but they extend only so far as their relationship to that company and not to the trust scheme itself. There are certain requirements imposed by the statutory covenants, and certain liabilities for contravention . . . But these do not match the standards expected of directors in relation to the corporate enterprise.[35]

There was considerable support for this proposal.[36] Several objections were raised, however.[37] First, the proposal was criticised on the ground that it would amount to lifting the corporate veil.

> In suggesting that directors of the [operator] assume the same obligations towards investors as the [operator] itself, the [Review] is in effect proposing that the corporate veil be lifted and creating a new regime at odds with the existing law. We do not think that it is necessary or desirable to do so.[38]

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29. See para 14.22.
30. See para 14.19.
31. 'Officers' means directors, the secretary and other executive officers. Executive officer' is defined in the Corporations Law s 9 as a person by whatever name called and whether or not a director . . . who is concerned, or takes part, in the management of the body.
32. See para 10.2.
33. Both at general law and under the Corporations Law: eg Corporations Law s 232. Although the position is not yet clear, it is argued by some that, at common law, directors also owe duties to shareholders.
34. Proposal 4.8. The term 'essential' is not used in this report because it does not recommend that there be duties from which the ASC cannot grant an exemption.
35. RA Hughes *The law of public unit trusts* Longman Professional 1992, 46.
36. eg Macquarie Investment Management Limited *Submission* 24 November 1992; FPAA *Submission* 7 December 1992; TCA *Submission* 17 December 1992; Attorney-General's Department *Submission* 21 December 1992.
37. eg Australian Film Commission *Submission* 7 January 1993; Arthur Robinson & Hedderwicks *Submission* 10 December 1992; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992.
38. Arthur Robinson & Hedderwicks *Submission* 16 December 1992.

Secondly, it was said that placing more onerous duties on directors would discourage people from accepting directorships, particularly independent directorships.[39] Thirdly, some submissions suggested that conflicts may arise between the duties that directors owe to the company and those that they owe to investors in schemes operated by the company.[40]

10.16 ***Imposing duties on officers.*** Officers of a scheme operator should pay close attention to the interests of the investors in the schemes operated by that company. They should prefer the company's interests to their own and prefer the investors' interests to the company's. Under the general law, the directors of a company owe fiduciary obligations to the company as a whole.[41] The Review considers that investors should have obligations owed to them by the officers of the operator. Investors should be able to take action against officers to enforce these rights directly, without first proceeding against the company. The nature of the rights should be modelled on the Corporations Law s 232. The precise form of the recommendations follows the provisions in the Corporations Law s 232, so that officers will not face additional kinds of liability under the proposal.

10.17 ***Conflict between duties to the operator and duties to investors.*** Officers of scheme operators will continue to owe to the operator the duties set out in the Corporations Law s 232. They will, consequently, owe duties both to the operator and to investors. Where any conflict arises, the latter duty should prevail. The Review **recommends** that this should be expressly provided for in the Corporations Law, and that officers should be given statutory protection from claims by the operator or its shareholders arising from any loss they suffered in consequence of officers complying with their paramount duties to investors.

10.18 ***Duty to act honestly.*** The Review **recommends** that the Corporations Law should impose on officers of scheme operators the duty to act honestly in all matters relating to the scheme.[42]

10.19 ***Duty to exercise reasonable care and diligence.*** The Review **recommends** that officers of scheme operators should, in exercising their powers and discharging their duties in respect of the scheme, exercise the degree of care and diligence that a reasonable person in a like position would exercise in similar circumstances.[43]

10.20 ***Duty to act in the interests of investors.*** The Review **recommends** that the Corporations Law should impose on officers of scheme operators the duty to act in the interests of investors and not in the interest of themselves, the operator or any other person where those interests are not identical to those of investors.

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39. St George Funds Manager Limited *Submission* 18 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992.
40. eg Freehill Hollingdale & Page *Submission* 8 December 1992.
41. Including duties to act in good faith, to avoid a conflict of interest and not to make improper use of their office.
42. See Corporations Law s 232(2).
43. This recommendation is modelled on the obligation to which officers are subject under the Corporations Law s 232(4). The Review notes the distinction being drawn by the courts in applying that obligation to executive and non-executive directors and other officers: see *AWA Ltd v Daniels* (1992) 7 ACSR 759; *ASC v Gallagher* (1993) 10 ACSR 43.

10.21 ***Not to make improper use of information or position.*** The Review **recommends** that the Corporations Law should prohibit an officer of a scheme operator from making improper use of information gained by virtue of his or her position as officer, to gain an advantage for himself or herself or for another person, or to cause detriment to the investors in the scheme.[44]

10.22 ***Duty to ensure that the scheme operator complies with the law.*** The Review **recommends** that an officer of an operator should be under a statutory duty to take all reasonable steps to ensure that the operator complies with all its obligations.

Related party transactions

10.23 ***Current law.*** The Corporations Law Pt 3.2A regulates the circumstances and manner in which a public company, and other entities it controls, may provide financial benefits to any of its directors or other related parties.[45] Its purpose is to protect public company shareholders against the possibility that the value of their investment will be eroded by non-arm's-length transactions. Investors in collective investment schemes need similar protection. At present a number of statutory covenants prohibit or regulate various transactions whereby trustees, management companies or their associates, might receive benefits from the assets of prescribed interest schemes.[46]

10.24 ***Proposal.*** DP 53 sought comment on whether the regulatory principles in the Corporations Law Pt 3.2A should apply to collective investment schemes. The majority of submissions favoured this approach.[47] One submission, however, was concerned that this would result in investors being able to vet the salaries of directors of scheme operators.[48] The related party provisions would not, however, be relevant to the payment of directors of the scheme operator because they would be paid by the operator, not by the scheme.

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44. cf Corporations Law s 232(5), (6).
45. Corporations Law Part 3.2A applies in relation to public companies from 1 February 1994.
46. Corporations Law s 1069(1)(g); Corporations Regulations reg 7.12.15(1)(d); 7.12.15(2)(b); 7.12.15(6)(k); 7.12.15(7)(c). See also NCSC Release 128 (eg para 110). This release is currently under review by the ASC.
47. eg T Valentine *Submission* 5 November 1992; TCA *Submission* 17 December 1992; FPAA *Submission* 7 December 1992; Hall Chadwick *Submission* 21 December 1992.
48. IFA *Submission* 1 December 1992.

10.25 ***Recommendation.*** The Review **recommends** that the principles in the Corporations Law Pt 3.2A, adapted for collective investment schemes,[49] should regulate transactions where a scheme operator, its associates[50] or any other related party[51] ('interested parties') could receive a financial benefit[52] from dealings involving scheme assets. These transactions should include:

- scheme assets being invested in an interested party or in a scheme operated by an interested party
- an interested party selling or leasing its property to the scheme
- an interested party acquiring or leasing scheme assets
- scheme assets being lent to, or provided as security for, an interested party
- debts or other obligations owed to the scheme by an interested party being forgiven, released or waived in whole or in part, or its lending terms varied.

Following the principles in Pt 3.2A, and taking into account the concerns expressed in submissions, the Review **recommends** that various transactions should be exempted. These are

- benefits provided to interested parties as scheme investors, if the payment is authorised by the scheme constitution or by the Corporations Law and does not constitute unfair discrimination[53]
- benefits provided on the same terms and conditions as would be provided to a non-interested party ('arm's-length' transactions)[54]
- benefits paid under a court order.[55]

The Review **recommends** that, subject to any prohibition or additional restriction in the scheme's constitution,[56] a non-exempt related party transaction should be permitted only if it is agreed to by a prior resolution of a simple majority of

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49. Pt 3.2A itself should not apply to the giving of benefits out of scheme property. The Review has drafted special provisions to apply to collective investment schemes. This will avoid the implication arising from the permissive way Pt 3.2A is drafted, that certain payments are allowed despite restrictions to the contrary in a scheme's constitution.
50. Associates include all related bodies corporate: Corporations Law s 11. 'Closely held' and 'child' entities of the scheme operator should not be excluded. The rationale for their exclusion in Pt 3.2A, merely that they do not involve the transfer of a public company's resources to an entity outside its control, does not apply under the different structure of collective investment schemes.
51. cf Corporations Law s 243F.
52. cf Corporations Law s 243G.
53. cf Corporations Law s 243PA.
54. cf Corporations Law s 243N. This will address the concern raised in one submission about scheme operators that undertake other commercial operations. It gave the example of a scheme operator having a separate corporate advisory division which stood to receive a success fee for the takeover of another company. As a result of a favoured bid price, the scheme managed by the scheme operator sold its shares in that company. It might be argued that the scheme operator helped its corporate advisory division to achieve its success fee and thus received a benefit from a transaction involving scheme assets: Macquarie Investment Management Limited *Submission* 24 November 1992.
55. cf Corporations Law s 243PB.
56. It is not clear what application the provisions of Pt 3.2A have to companies operating collective investment schemes. On one interpretation provisions that allow certain payments to be made could override restrictions in a scheme constitution.

disinterested investors, provided they have been fully informed about the transaction and its likely impact upon the scheme.[57] The ASC must be given the opportunity to comment on the transaction before it is considered by investors.[58] A scheme operator and any other persons involved in a breach should be subject to criminal or civil liability under the civil penalty provisions.[59]

10.26 ***Retirement benefits for operators.*** The Corporations Regulations prescribe a covenant that the trustee or management company will not accept a payment in relation to retirement from office that has not been approved by the votes of the holders of 50% or more of the value of the prescribed interests.[60] The Review supports the principle behind this covenant. It **recommends** that investor approval should be required for the giving of any direct or indirect payment or other benefit from scheme assets to any person in relation to the retirement from office of the scheme operator or any of its officers, including employees. Approval should require the affirmative vote of the holders of more than 50% of the value of the voting interests in the scheme.

Financial stability of scheme operators

A capital requirement

10.27 ***DP 53 proposal — no capital requirement.*** DP 53 raised the issue whether scheme operators should, in all or some circumstances, be subject to a minimum capital requirement. The DP noted that a capital requirement might be justified on any of the following grounds:

- it could provide some indication of the capacity of the operator to conduct funds management operations and to continue as a going concern ('skill money')
- it could provide evidence of the commitment by the operator to its scheme management activities ('hurt money')
- it could be a pool of funds for investors who succeed in litigation against an operator for breach of duty ('comfort money').

DP 53 concluded that a capital requirement would not necessarily serve any of these purposes well enough to warrant its imposition.[61]

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57. cf Part 3.2A Div 5; s 243ZF.
58. cf Corporations Law s 243W.
59. Some consequential amendments will need to be made to the Corporations Law Part 9.4B, for instance, any compensation recovered under Pt 9.4B Div 5 should be treated as scheme assets. The exemption from liability for the public company under the Corporations Law s 243ZE is intended to ensure that the interests of its shareholders are not affected. There is no equivalent rationale for exempting a scheme operator from liability, given that the operator would not have any recourse against the assets of the scheme.
60. Corporations Regulations reg 7.12.15(1)(d).
61. See DP 53 para 5.17-5.23. The Review proposed that the operator of a collective investment scheme should not have to have a prescribed amount of capital if it did not trade on its own account: proposal 5.7. It raised as an issue whether operators that do trade on their own account should be subject to a capital requirement: issue 5E.

10.28 ***Submissions and consultations.*** Some submissions supported the proposal for no capital requirement.[62] Many criticised it, however, principally on the ground that scheme operators would not have to show evidence of commitment to the funds management industry.[63]

> We strongly contend that investors' interests are not well served by not having a minimum capital requirement for [operators]. A minimum capital requirement is demonstration of [an operator's] commitment to the industry, and of its substance and credentials to perform collective investment responsibilities. It also offers investors an added degree of security and is a sensible fiduciary discipline on [operators] who would not want to expose their capital base.[64]

It appears that an element of comfort is gained from a capital requirement, despite widespread acknowledgment that any amount chosen will be arbitrary and, for some schemes, inappropriate. A capital requirement is also seen by many as some protection against institution risk.

10.29 ***Addressing institution risk.*** Institution risk, identified in chapter 2 as the risk that the operator of a collective investment scheme will collapse, is not addressed directly in the existing regulation of prescribed interest schemes. The ASC may impose financial conditions and restrictions on a manager by way of conditions on its dealers licence.[65] It usually imposes a condition that surplus liquid funds of $50 000 (or net tangible assets of $20 000), or 5% of adjusted liabilities, must be maintained at all times.[66] Given that the amount of assets under management, even in a medium size unit trust, can be several million dollars, and that very few (if any) managers operate only one scheme, the protection such a control affords may not be significant.

10.30 ***Survival of the scheme not enough.*** The Corporations Law deals with institutional risk by providing that the trustee or representative may manage a scheme and arrange for a replacement manager if the original manager collapses, Accordingly, institution risk is not seen by some participants in the collective investments industry as a major concern. However, the identity of the manager may have been a significant factor in investors' decision to choose that particular scheme. Consequently, they are interested in the fate of their preferred manager. The Corporations Law only provides a mechanism that enables the scheme to continue. The Review's recommendations about appointment of temporary scheme operators also provide a mechanism to enable schemes to continue in the event that the scheme operator collapses. However, they do not do anything to reduce the risk of this event occurring. The Review considers that it is appropriate that the law

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62. eg County NatWest Australia Investment Management Limited *Submission* 18 December 1992; Law Council of Australia *Submission* 16 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; Credit Union Services Corporation Limited *Submission* 27 November 1992; Australian Film Finance Corporation Pty Ltd *Submission* 8 December 1992.
63. eg National Mutual *Submission* 3 December 1992; T Valentine *Submission* 5 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; MLC Investments Limited *Submission* 17 December 1992; TCA *Submission* 17 December 1992.
64. MLC Life Limited *Submission* 18 December 1992.
65. Corporations Law s 786(2)(c).
66. NCSC Release 333 para 78, which has been adopted by the ASC.

address institution risk. The Corporations Law should require scheme operators to meet a minimum capital requirement for two reasons. First, it would provide the proprietors of a scheme operator with some incentive to make sure the operator did not collapse. A minimum capital requirement would also help to avoid the situation where an operator with little or no financial substance, and which is not guaranteed by its parent company, contracts the management of a scheme to its well-capitalised parent company (which will benefit from the arrangement through the fees it receives). The operator will be responsible for the scheme, but that will be little comfort to investors who may be unable to recover anything of substance from it. Nor would they be able to seek payment from the parent company.[67] Investors could suffer. The scheme operator and its parent company may lose nothing but (perhaps) their reputations. Several submissions addressed such a possibility.[68] Secondly, a capital requirement would provide at least some assets against which investors could claim if the operator is held liable for loss suffered by investors.

10.31 ***A minimum capital requirement.*** The Review **recommends** that the Corporations Law should impose a minimum capital requirement on scheme operators. The level of capital required should be calculated by reference to the total value of the assets of the operator's schemes. After consultations and submissions on this matter, the Review considers that the capital requirement should be set at 5% of the value of the assets of all schemes operated by the operator, subject to a minimum of $100 000 and a maximum of $5m.[69] 'Capital' should mean the net value of the scheme operator, that is, the book value of the property that the operator owns beneficially less the operator's actual and contingent liabilities. For the purposes of calculating an operator's net value, interests in a scheme operated by the operator, or an associate of the operator, should not be counted. The 'value of scheme assets' should mean their accounting or book value.[70] The relevant figures should be drawn from each scheme's most recent financial statements.[71] For a scheme operator responsible for more than one scheme, the value of each scheme's assets should be added together to determine the minimum level of capital required, although this may involve calculations concerning schemes that have different balance dates. There may be some measurement error due to book values being out of date, but this is the most appropriate procedure on cost-benefit grounds. A scheme operator should not commit an offence immediately its capital level falls below the statutory

67. The scheme operator would be unlikely to seek an indemnity from the parent company. However the ASC could act on behalf of the scheme operator, with or without its consent, to sue the investment manager: see ch 14.
68. eg Permanent Trustee Company Limited *Submission* 12 November 1992.
69. eg a scheme operator with schemes that have a total of $6m worth of assets would need $300 000 (5% of $6m) capital.
70. A scheme operator would have incentives to reduce funds under management by adopting asset-reducing valuation practices. Elsewhere in this report, the Review recommends that accounting standards for collective investment schemes should be determined by the Australian Accounting Standards Board: para 5.32.
71. The Review recommends that the financial statements of a collective investment scheme should be prepared on a half-yearly basis: para 5.31.

requirement. It should, however, be required to notify the ASC promptly. The Review **recommends** that it should be an offence for a scheme operator to have a capital level below $100 000 or to have, for a period of 14 consecutive days, capital less than that required.

Scheme operator not to guarantee or indemnify

10.32 Corporate financing arrangements are becoming increasingly complex. Where companies are part of a group, their financing arrangements sometimes include intra-group guarantees of loans, one member guaranteeing loans taken out in the name of another member of the corporate group. A guarantee or indemnity of any kind by a scheme operator could increase the institution risk associated with a collective investment scheme, in particular the disruption caused to the running of the scheme should it be necessary to appoint a temporary scheme operator. The Review **recommends**, therefore, that scheme operators should be prohibited from guaranteeing or providing any indemnity in respect of loans, whether the loan is to another member of the corporate group or not.[72]

Insurance

10.33 ***Professional indemnity insurance.*** DP 53 sought comment on whether scheme operators should have to maintain professional indemnity insurance and, if so, whether its level should be prescribed.[73] If schemes had to be insured, investors would obtain some compensation in the event of loss through the negligence of the scheme operator, even if the scheme operator also lost all its assets. The issue was raised in the context of the Review's proposal not to impose a capital requirement on scheme operators. Several submissions favoured compulsory professional indemnity insurance.[74] Others did not, pointing out the high cost of such insurance and the control it might give insurance companies over who could participate in the industry.[75] Given the difficulties of prescribing a standard policy and the Review's decision to recommend a minimum capital requirement for scheme operators, the Review does not consider it necessary to require scheme operators to maintain professional indemnity insurance. The decision to take out such insurance should be a matter for each scheme operator. Some submissions suggested that whether a scheme operator has professional indemnity insurance and, if it does, the details of it, should have to be disclosed.[76] The Review considers that this matter should be left to the operation of disclosure provisions such as the Corporations Law s 1022.

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72. The Review recommends in ch 6 that borrowing by a scheme operator on behalf of a scheme should be restricted to 10% of the value of the scheme's assets, unless the name of the scheme includes a word that indicates it can, or will, borrow more than 10%: para 6.10.
73. Issue 5D.
74. eg Minter Ellison Morris Fletcher *Submission* 19 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992.
75. eg Arthur Robinson & Hedderwicks *Submission* 10 December 1992; Law Council of Australia *Submission* 16 December 1992.
76. Mercantile Mutual Holdings Limited *Submission* 16 December 1992; ASCPA & ICAA *Submission* 15 February 1993.

10.34 ***Fraud insurance.*** DP 53 also asked whether fraud insurance for scheme operators is desirable. Several submissions considered it desirable but did not favour its being made compulsory.[77] Others considered the cost of such insurance and the difficulties involved in prescribing a standard level of cover to be prohibitive.[78] The Review is not convinced that it would be possible for all operators to obtain such insurance at a feasible price. Nor would it be possible to standardise the terms of all policies. The benefit of fraud insurance would vary from case to case. The Review also acknowledges the argument that insurance companies might gain de facto control over the industry as they could determine who could participate and how many new products could come onto the market and when. The Review does not recommend that fraud insurance be required for all operators. This should be a matter for individual operators.

Licensing scheme operators

The licensing system

10.35 ***Why license operators?*** Licensing is an effective way of imposing and monitoring the controls that the Review recommends for scheme operators. The Corporations Law does not expressly require managers of prescribed interest schemes to be licensed. Nevertheless, some form of licensing or approval is, effectively, required. A dealers licence is required if a person carries on a business of dealing in securities.[79] Because the ASC takes the view that issuing units in a prescribed interest scheme constitutes such dealing in securities,[80] managers of these schemes must have a dealers licence whether or not they deal in securities of other corporations. Trustees and representatives must also be approved by the ASC.[81] The Review agrees that licensing should be a feature of the regulatory framework. Licensing will enable the regulator to screen out insolvent companies, those that do not have the required level of capital and those that do not have adequate compliance measures. Licensing provides a means of monitoring the operations of schemes and imposing any necessary changes to the scheme's operation through licence conditions. It will also provide the ASC with information about the industry, which is particularly important for the purpose of surveillance. The Review **recommends** that all scheme operators should be licensed. It should be an offence for any person other than a court appointed temporary scheme operator or the administrator or liquidator for a scheme[82] to operate a collective investment scheme or to issue interests in a collective investment scheme without a licence.

10.36 ***What type of licence?*** DP 53 proposed that scheme operators should hold a special type of dealers licence. This suggestion was made because it was thought that licensing operators within the existing licensing regime for dealers would be

77. eg AMP Society *Submission* 30 November 1992.
78. St George Funds Manager Limited *Submission* 18 December 1992; BT *Submission* 15 December 1992.
79. Corporations Law s 780.
80. See Policy Statement 16, para 8.
81. Interests in prescribed interest schemes can only be issued pursuant to an approved deed and a deed cannot be approved unless the trustee or representative appointed by the deed has been approved: Corporations Law s 1065, 1066.
82. The liquidator of a scheme can carry on the scheme but cannot issue interests in it.

more practical than establishing a separate licensing regime, especially given that many operators would be dealing in other securities quite apart from issuing units in their schemes. The Review has reconsidered this proposal. The criteria that should be relevant for licensing companies as scheme operators are different from the existing criteria for licensing dealers or investment advisers.[83] Accordingly, the Review **recommends** that there should be a scheme operators licence which is separate from dealers and advisers licences. The licence should entitle a scheme operator to deal in interests in its own scheme. It should also permit a scheme operator to advise investors about investing in the operator's scheme.[84] A scheme operator that proposes to deal in other securities in the course of managing a scheme, for example, if the scheme invests in equities, will need a dealers licence in addition to an operators licence.[85]

10.37 ***Licensing should focus on compliance.*** The main focus of the licensing process should be to reduce compliance risk.[86] It should do this in two ways. First, the primary factor that the ASC should consider when dealing with licence applications is the compliance measures the applicant proposes to implement. The ASC should be able to reject an application if it considers that the proposed compliance measures are not reasonably likely to detect in advance and prevent a possible breach of the law or the scheme constitution. Secondly, the directors of the applicant should be required to endorse the compliance measures that are to be imposed as licence conditions and certify that, in their opinion, the measures are adequate and can be implemented.

10.38 ***ASC's ability to check proposed compliance measures.*** Recently, the ASC has begun paying close attention to the systems and resources of trustee companies. It is gaining increased experience in vetting those companies before approving them as trustees for prescribed interest schemes.[87] The developing expertise of the ASC in this area will help it to assess whether proposed compliance measures meet the required standard.

10.39 ***Licence not a guarantee of compliance.*** No system of regulation, including that recommended in this report, can guarantee compliance. Licensing will not, and cannot, constitute a guarantee that the law will never be breached. The Review's proposed regime will, however, ensure that all scheme operators are made to focus on compliance and institute appropriate measures, before they commence a scheme.

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83. See para 10.43, 10.44.
84. See para 13.4.
85. In its report *Collective investments: superannuation* (ALRC 59, 1992) the Review stated that it would review the requirements for dealers licences as part of its review of collective investments. Because the Review recommends the introduction of a scheme operators licence, the issue of the standards for dealers licences has become less relevant in the context of this report and is not addressed.
86. The reasons for focusing on compliance were discussed in ch 9.
87. Until recently, it seemed that the ASC relied too much on the fact that statutory trustee companies have been approved under State or Territory legislation, which varies between jurisdictions. If the proposed trustee for a prescribed interest scheme is a trustee company, the ASC does not consider the company's resources and ability in respect of that particular scheme nor does it give consideration to the impact of other schemes in respect of which the applicant is acting as an approved trustee or representative on its capacity to handle additional work: NCSC Release 126 para 4. It does consider these factors if the proposed trustee is not a statutory trustee company.

10.40 ***Not necessarily a defence to proceedings.*** If a court determines that an operator was taking all reasonable measures to prevent relevant contraventions of the law and the scheme constitution, the operator should have a defence to some criminal and civil penalty proceedings in some circumstances.[88] The fact that the operator is complying with the conditions of its licence which relate to compliance will not necessarily establish the defence. It may be considered by the court but the determination whether the measures the defendant took were reasonable is for the court.

The licensing process — assessing compliance measures the main consideration

10.41 ***Register of operators.*** Under the Corporations Law, the ASC must keep a register of the holders of securities dealers licences and investment advisers licences.[89] The Review **recommends** that the ASC should keep a register of licensed operators of collective investment schemes. The information to be kept on the register should include the name and ACN of the operator, a copy of the operator's licence and any conditions imposed by the ASC noted on it, the name and registration number of each scheme that the company operates and the names of the directors of the scheme operator. The register should be made available for any person to inspect and to copy.

10.42 ***Application for a scheme operators licence.*** An application for a scheme operators licence should be made to the ASC in writing and in accordance with a form approved by the ASC. The application should include, among other things

- the applicant's name and ACN
- a copy of the scheme's constitution
- in respect of each director of the applicant, a statement signed by the director setting out whether he or she has been associated with the applicant or an associate of the applicant in the previous three years and whether he or she has a shareholding in the applicant or an associate of the applicant
- the name and registration number of other schemes (if any) that the applicant operates
- a summary of the proposed compliance measures.

The ASC should be able to ask for further information.

10.43 ***ASC to consider compliance measures.*** An applicant should not have a right to a scheme operators licence. The Review **recommends** that the ASC should be required to consider whether the compliance measures summarised in the application are reasonably likely to detect in advance and prevent contraventions of the law or of the scheme's constitution. If the ASC considers that the measures disclosed in the summary or otherwise known to it are not likely to do so, it should be able either to refuse to grant a licence, stating its reasons, or to grant a licence subject to conditions to observe specified compliance measures.[90]

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88. The draft legislation in Volume 2 of this report indicates in respect of each offence whether the defence applies.
89. s 789.
90. For conditions that may be imposed, see para 10.46.

10.44 ***Factors to be taken into account.*** While there is a need for flexibility in compliance measures, there are certain fundamental matters concerning the way an applicant proposes to operate a scheme that the regulator should always examine when considering proposed measures. These matters should be specified in the Corporations Law both to guide the ASC and to help applicants prepare their licence applications. The Review **recommends** that the law should set out a non-exhaustive list of compliance factors that the ASC must take into account in considering licence applications. They include

- arrangements for holding the scheme property, including procedures to ensure the separate identification of scheme assets
- measures for separating decision making relating to the investment and expenditure of scheme property from the implementation of those decisions
- arrangements for auditing the scheme, including the frequency of audits by internal and external auditors
- arrangements for keeping the records of the scheme.

In addition the ASC should take into account any report commissioned by the applicant (and submitted to the ASC) as to the adequacy of the compliance measures proposed and any matter which the ASC considers relevant to the evaluation of those compliance measures. The Review envisages that, in due course, the ASC will develop more detailed guidelines to assist applicants in determining what compliance measures are adequate for particular kinds of schemes. The ASC should, nevertheless, still have to consider in each case the adequacy of the proposed compliance measures for the particular scheme.

10.45 ***Custody arrangements a factor in assessing compliance risk.*** The arrangements under which a scheme's assets are held, whether by the scheme operator or by an external custodian, will be relevant to the compliance risk of a scheme.[91] Accordingly, these arrangements should be examined closely by the ASC. It should be left to the ASC to determine whether the compliance measures for a scheme in which the operator holds the legal title will be reasonably likely to detect in advance and prevent possible non-compliance.[92] Likewise, if a scheme operator chooses to place the scheme property with another person, the ASC will have to consider the proposed compliance measures in light of that arrangement. The ASC will need to consider the capacity of the proposed external custodian to perform its role, as specified in the agreement between it and the scheme operator. The Review **recommends** that, in considering whether proposed compliance measures are reasonably likely to detect in advance and prevent a potential breach of the law, the ASC should take into account who will have the legal title to the scheme's assets and, if an external custodian is to have legal title, the arrangements between the proposed custodian and the operator.

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91. See also discussion at para 9.15, 9.16.
92. Any custody arrangement will set out the circumstances in which the custodian will release the assets, eg, on instructions from a particular officer of the scheme operator, on instructions plus proof that the transaction is completed etc. There seems no reason why the same level of protection against fraud cannot be achieved if similar procedures were set up within a scheme operator.

10.46 ***Conditions on licences.*** There should be specified grounds on which the ASC must refuse to grant a licence.[93] Unless the applicant is refused a licence on one of those grounds, or the ASC considers that the applicant's compliance measures are not reasonably likely to detect in advance and prevent contraventions, the ASC must notify the applicant that it will issue a licence subject to the conditions contained in the notice. The conditions must relate to compliance. They may be the measures summarised in the application, additional or substitute measures, conditions limiting or restricting the activities of the scheme to activities for which the compliance measures summarised by the applicant are appropriate or any combination of these.

10.47 ***Directors of operator to endorse conditions.*** The notice setting out the conditions that the ASC proposes to impose on the applicant's licence must be examined by the applicant's directors with a view to determining whether, in their opinion

- the conditions are reasonably likely to detect in advance and prevent possible breaches of the law and the scheme constitution and
- the operator is capable of complying with them.

The Review anticipates that in some cases there may be a process of negotiation between the ASC and the applicant about the proposed conditions. The Review **recommends** that the directors of the operator should, before the ASC grants the licence, certify that they have examined the conditions proposed by the ASC and that they are satisfied that they are reasonably likely to detect in advance and prevent possible breaches of the law and the scheme constitution and can be put into effect by the applicant if the application is granted. This will impress on directors the importance of the conditions of the licence and will commit the operator to the compliance measures suggested by the ASC. This approach will achieve a focus on addressing compliance risk without introducing inflexibility into the regime. It may also reduce the risk that an operators licence will be seen as some sort of guarantee by the ASC that the operator will comply with the law. If the directors are not prepared to sign off on the conditions suggested by the ASC, and the ASC is not prepared to amend the conditions, the applicant should be able to seek review of the ASC's decision by the Administrative Appeals Tribunal.

Operator to comply with licence conditions

10.48 A scheme operator must comply with the conditions imposed on its licence. Failure to do so should be a contravention of the Law but should not be an offence. An operator should have to advise the ASC immediately it breaches a licence condition. Failure to advise the Commission will be an offence.[94] A breach of a condition will trigger the ASC's investigative powers and may lead to the ASC revoking the operator's licence. The operator will have to show to the ASC that what it was doing by way of compliance measures was at least as good as the licence conditions. This will force operators to give effect to compliance measures at

93. These are dealt with at para 10.52-10.55.
94. Corporations Law s 787.

least as effective and thorough as those imposed by the ASC and which their directors have themselves certified as adequate to reduce compliance risk.

Changing compliance measures

10.49 A scheme operator may, at its own initiative, employ additional compliance measures in respect of one or more of its schemes.[95] If it otherwise wishes to alter its compliance measures as specified as a condition of the licence, it must seek approval from the ASC. Unless the ASC considers that the proposed measures are not reasonably likely to detect in advance and prevent a possible breach of the law, it may substitute those measures by imposing different conditions on the operators licence. The ASC may itself initiate changes to the conditions of the operator's licence at any time.

Operator's qualifications and experience

10.50 Before granting a securities dealers or investment advisers licence, the ASC must be satisfied that the applicant's educational qualifications and experience are adequate having regard to the nature of the duties of a holder of a licence of the kind applied for.[96] The Review has considered whether a similar test should be applied to the officers of the applicant for a scheme operators licence. There was some support in consultations for requiring the ASC to exclude individuals that the ASC considers to be incompetent. The Review does not consider it appropriate to make the ASC the arbiter of a person's competence, based on education and experience, to operate collective investment schemes. The market should perform that role, as it does in the corporate sphere. Consideration of these factors may impinge, however, on the judgment of the ability of identified individuals to implement and maintain the proposed compliance measures. The law should not require the regulator to be otherwise satisfied that the qualifications and experience of the officers of an applicant for a scheme operators licence meet any particular standards.[97]

Keeping out dishonest or insolvent participants

10.51 ***Reducing compliance risk.*** Chapter 9 noted that the participation in the collective investments industry of corporations and individuals with a history of dishonest behaviour is likely to increase the compliance risk faced by investors. The licensing process should be used to screen such people before they are allowed into the industry.

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95. It may wish to do so, for example, to improve its systems and to increase the likelihood of being able to prove a defence if it should be prosecuted for a breach of the law.
96. s 783(2)(c). In the case of a corporate applicant, the ASC must be satisfied that each responsible officer of the applicant has educational qualifications and experience that are adequate 'having regard to the duties that the officer would perform in connection with the holding of the licence': Corporations Law s 784(2)(c). 'Responsible officer' is defined in the Corporations Law s 9 to be an officer of a body corporate who would perform duties in connection with the holding of the licence.
97. The qualifications and experience required in respect of dealing in or advising on interests in collective investment schemes are discussed in ch 13.

10.52 ***External administration.*** A company that is externally administered should not be permitted to operate a collective investment scheme.[98] The solvency of the officers of a company is also relevant to compliance risk. No insolvent under administration may be an officer of a corporation.[99] The Review **recommends** that the Corporations Law should provide that the ASC must reject an application for a scheme operators licence if the applicant is externally administered or one of its officers is an insolvent under administration.

10.53 ***Conviction for serious fraud.*** Individuals with a current record of dishonesty should not be allowed to participate in the operation of collective investment schemes. DP 53 proposed that, because of the high standards expected of the operators of collective investment schemes, a conviction for serious fraud[100] should automatically exclude a person from operating a collective investment scheme.[101] It also proposed to exclude a company if any of its responsible officers have been convicted of serious fraud.[102] These proposals received wide support.[103] The Review remains of the view that it is inappropriate for an individual convicted of a serious fraud to be an officer of a scheme operator. It notes that, under the Corporations Law, a person who has been convicted of serious fraud is prohibited from managing a corporation for five years after the conviction or, if the person was sentenced to imprisonment, after release from prison.[104] The Review **recommends** that the Corporations Law should provide that the ASC must refuse to grant a scheme operators licence if any officer of the applicant has been convicted of serious fraud in the past five years, has not been released from prison for more than five years after serving a sentence for a conviction for serious fraud or is otherwise prohibited from managing a corporation. A company that has such an officer and that wishes to operate a scheme will have to remove the convicted person from any executive position. The Review no longer considers, however, that a company that has been convicted of serious fraud should be automatically precluded from operating a scheme. The conviction may be a very old one. The company may well have dismissed the officer or officers whose actions led to the company's conviction

98. 'Externally-administered body corporate' is defined in the Corporations Law s 9 and includes a body corporate that is being wound up or in respect of property of which a receiver has been appointed. In many instances, such a company would, in any case, be unlikely to be able to fulfil the recommended capital requirement: see para 10.31.
99. Corporations Law s 229(1).
100. As defined in the Corporations Law s 9: an offence involving fraud or dishonesty, being an offence against an Australian law or any other law and punishable by imprisonment for life or for a period, or maximum period, of at least 3 months.
101. Subject to the spent convictions provisions of the *Crimes Act 1914* (Cth): proposal 5.2. In most cases, a conviction is spent after 10 years have passed since the date of conviction, provided the person was not sentenced to imprisonment or was sentenced to imprisonment for the offence for no more than two and a half years. If the person was dealt with as a minor the conviction is spent after five years: *Crimes Act 1914* (Cth) s 85ZM. This proposal applied to both corporate and individual applicants because DP 53 did not propose that operators be required to be corporations.
102. Subject to the spent convictions provisions of the *Crimes Act 1914* (Cth): proposal 5.2. 'Responsible officer' is defined in the Corporations Law s 9 to be an officer of a body corporate who would perform duties in connection with the holding of the licence.
103. eg T Valentine *Submission* 5 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; IFA *Submission* 1 December 1992; ISC *Submission* 12 November 1992; St George Funds Manager Limited *Submission* 18 December 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
104. s 229.

and taken other steps to ensure that fraud does not recur. It **recommends**, nevertheless, that an applicant for a scheme operators licence should be obliged to disclose to the ASC in its application any conviction for serious fraud and the circumstances in which it arose. The ASC must take into account that fact and whether the applicant has taken steps reasonably likely to prevent a similar fraud being committed again.

10.54 ***Civil penalty for act of dishonesty.*** DP 53 proposed that a corporation that has been subject to a civil penalty imposed for an act of dishonesty, or one of whose responsible officers has been subject to such a civil penalty, should not be permitted to operate a collective investment scheme.[105] This proposal was supported in submissions.[106] The Review still considers it appropriate to prevent dishonest individuals from being involved in the operation of collective investment schemes. The Review **recommends** that the Corporations Law should provide that the ASC must refuse to grant a scheme operators licence if any officer of the applicant has been subject to a civil penalty for an act of dishonesty in the five years before the application is made or is otherwise prohibited from managing a company.[107] The Review now considers that, as with convictions for serious fraud, a company that has been made subject to a civil penalty for an act of dishonesty should not be automatically disqualified from operating a collective investment scheme. Whether the company should be refused a licence should depend instead on what steps it has taken to ensure that such a breach does not occur again. The Review **recommends** that, if the applicant has been subjected to a civil penalty for an act of dishonesty, this fact should be disclosed to the ASC. The ASC should consider it in assessing the application. Particular consideration should be given to how long ago the penalty was imposed, whether the officer whose actions led to the penalty being imposed is still an officer of the company and whether the company has taken steps which are reasonably likely to prevent a similar act of dishonesty taking place again. If the ASC is satisfied that those steps have been taken, the applicant should not be refused a licence merely because of the penalty.

No licence if fewer than half directors are non-executive

10.55 Chapter 9 noted the Review's view that non-executive directors are able to play a role in reducing compliance risk. The Review **recommends** that the ASC should refuse to grant a scheme operators licence to an applicant unless at least half of its directors are non-executive. Scheme operators will have to provide details about their directors when applying for an operators licence. The details will include whether the directors are associated with the operator or an associate of the

105. Proposal 5.3.

106. eg JP McAuley *Submission* 23 November 1992; ASCPA & ICAA *Submission* 15 February 1993; Mercantile Mutual Holdings Limited *Submission* 16 December 1992; FPAA *Submission* 7 December 1992.

107. A civil penalty will include a penalty imposed under the Corporations Law Pt 9.4B for breach of a civil penalty provision. An example of other civil penalties includes civil penalties imposed under the *Trade Practices Act 1974* (Cth). Pt 9.4B provides for the court to make an order prohibiting a person from managing a corporation for a period specified in the order: s 1317EA(3)(a). Managing a corporation is defined, for the purposes of specified sections, in s 91A.

operator and whether they have any shareholding in the operator or its associates. From this information, the ASC will be able to assess whether the requirement that at least half the directors of an operator be non-executive is satisfied.[108]

Updating a scheme operators licence

10.56 A scheme operator must apply to the ASC to have any additional scheme registered and the registration number endorsed on its licence. Before doing so, the ASC must consider whether the compliance measures that the operator proposes for the new scheme, whether they are new or are the same measures that the operator has for its existing schemes, are likely to detect in advance and prevent a potential breach of the law or of the additional scheme's constitution. The ASC must consider whether there will be any reduction in the capacity to detect and prevent a breach of the law or the constitution of the schemes currently endorsed on the licence. The agreed upon compliance measures must be made conditions of the operator's licence.

Voluntary retirement of scheme operator

10.57 A scheme operator may wish to retire as the operator of one or more of its collective investment schemes. It is important that schemes not be left without an operator. An operator should not be allowed to retire unless it has arranged for a replacement operator.[109] It could ask investors to approve a replacement operator. Unless and until this occurred, it would have to remain as the operator or obtain court appointment of a temporary operator. The Review **recommends** that the Corporations Law should provide that a company may not retire as operator of a collective investment scheme until a replacement operator has been appointed.

108. Failure to maintain the required proportion of non-executive directors should be grounds for revocation of a scheme operators licence: see para 14.30. It should also be an offence: see para 9.10.

109. A proposal in DP 53 to this effect (Proposal 5.11) received wide support. See, eg, FPAA *Submission* 7 December 1992; ISC *Submission* 12 November 1992; MLC Investments Limited *Submission* 18 December 1992.