6. Financial controls on collective investment schemes

Introduction

6.1 Prescribed interest schemes are not subject to significant financial controls or strict prudential supervision. This chapter considers what financial controls on collective investment schemes are necessary to provide investors with appropriate protection against the institution or compliance risks associated with those schemes.[1]

Liquidity controls

Controls of general application

6.2 Only one financial restriction applies generally to prescribed interest schemes: holders of dealers licences must usually hold at all times surplus liquid funds of $50 000 (or net tangible assets of $20 000) or 5% of adjusted liabilities.[2] Other existing controls are the result of either institutional regulation or, in the case of unlisted property trusts, special circumstances. The lack of financial controls on prescribed interest schemes reflects the fact that investment risk in such schemes is borne by investors, not by the scheme operator.

Liquidity controls on unlisted property trusts

6.3 The collapse of the property market resulted in the introduction of financial controls for property trusts. A property trust is defined in the Corporations Law to be a trust where at least 20% by value of the trust property is real property or that is promoted as a trust where at least 20% by value of the trust property is to be real property.[3] The manager of an unlisted property trust must maintain the combined liquidity of the trust at 15% of the trust's assets value, calculated on the basis of a rolling three month average. The combined liquidity of the trust is the liquidity of the trust plus an amount calculated with reference to the management company's liquidity, its assets and the net tangible assets of the trust.[4] The increased liquidity requirement is designed

> to ensure that buy-back and redemption requests may be met when due for payment.[5]

1. For a discussion of the kinds of risks collective investment schemes face see ch 2.
2. NCSC Release 333, adopted by the ASC.
3. Corporations Law s 1076A.
4. Corporations Regulations reg 7.12.15A.
5. ASC Policy Statement 16 para 15.

Proposal and submissions

6.4 DP 53 proposed that operators of collective investment schemes that offer to redeem investments within seven days should have to ensure that the scheme has either a prescribed percentage of funds, for example 5% of adjusted liabilities, in cash or an equivalent amount in lines of credit with a deposit taking institution.[6] It also proposed that operators of 'illiquid' collective investment schemes should be required to keep a fixed proportion of possible redemptions, say 50% calculated over a three month period, in liquid funds.[7] The rationale for the proposal was to ensure that, in the case of schemes offering payment of redemption requests within seven days, that is, 'liquid' schemes, schemes that experienced delays or difficulties in selling 'liquid' assets would still be able to pay out investors on time, thereby maintaining investor confidence in the ability of schemes to pay them out on time.[8] In the case of illiquid schemes the rationale for the proposal was to assist operators of such schemes to manage their cash flows.[9] Few submissions supported the proposal for a liquid assets requirement for 'liquid' schemes.[10] Most were concerned that requiring these schemes to maintain a level of liquid assets at all times may have the effect of making those assets the most illiquid of the scheme's assets because they would not be able to be used. There was also evidence of an assumption that 'liquid' schemes by definition cannot have a liquidity problem.[11] There was more support for a liquidity requirement for 'illiquid' schemes, but some considered it too prescriptive.[12] Submissions favoured making the scheme operator responsible for matching liquidity and investor redemption intentions as revealed by redemption notices.[13] One submission suggested no controls on liquidity were required if the Review's proposals 8.2 and 8.3 were adopted.[14]

Recommendation

6.5 Many collective investment schemes have been marketed to investors as a form of savings they can access relatively easily. The ability of schemes to meet redemption requests, therefore, has been essential for investor confidence. It is difficult to legislate to ensure liquidity by prescribing a minimum liquidity standard. Operators need to monitor their likely cash flow needs rather than simply meet a legislated minimum liquidity requirement. The Review does not need to recommend a minimum liquidity requirement for any schemes. Fully liquid schemes, by their very nature, will always have liquid assets available to

6. Proposal 9.1. Under DP 53 proposal 8.2 only 'liquid' schemes would be able to offer redemption at call.
7. Proposal 9.1.
8. DP 53 para 9.7.
9. DP 53 para 9.8.
10. Those that did included T Valentine *Submission* 5 November 1992; TCA *Submission* 17 December 1992; Attorney-General's Department *Submission* 21 December 1992.
11. eg ANZ Funds Management *Submission* 21 December 1992.
12. St George Funds Manager Limited *Submission* 18 December 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
13. IFA *Submission* 1 December 1992; BT *Submission* 15 December 1992.
14. Arthur Robinson & Hedderwicks *Submission* 16 December 1992. These proposals dealt with prescribed liquidity controls for schemes offering redemption at call or and fixed term investments.

meet redemption requests. Other schemes will not be required to meet redemption requests beyond the capacity of the scheme, at any particular time, to pay.[15] Accordingly, the Review **recommends** that the Corporations Law should not prescribe a minimum liquidity requirement.

Borrowing controls

Current controls

6.6 Before the collapse of the property market, there were no controls on gearing by prescribed interest schemes. Several property trusts that experienced problems in 1991 were highly geared. As part of its response to these problems, the ASC proposed that unlisted property trusts be subject to a borrowing limit of 20% of the gross assets of the fund.[16] Trustee companies in most States are subject to controls on the amount they can borrow.[17]

Should borrowing be controlled?

6.7 *The case for borrowing controls.* The case for borrowing controls on collective investment schemes rests on the argument that collective investment schemes are investment schemes, not gearing arrangements. It may also be argued that most investors make their decision to invest in a particular scheme on the basis of the anticipated rate of return and the kind of assets to be invested in by the scheme. The ability of the scheme to borrow, or its level of borrowing, is not generally a key factor in their decision. Nor do all investors appreciate the implications for their investment of a scheme's decision to borrow. The difficulties experienced by the more highly geared property trusts also suggest that market disciplines, which should prevent collective investment schemes from borrowing more than they can afford, are not sufficiently robust to be relied on. This element of market failure would not ordinarily be cause for comment. However, in this instance it contributed to the federal Government becoming involved in arranging a solution to the property trust industry's problems. Collective investment schemes in several overseas jurisdictions are subject to borrowing restrictions. The UCITS directive, for example, restricts borrowing to 10% of the value of a scheme's assets. In Hong Kong schemes may borrow up to 25% of the value of their assets. A number of responses to IP 10 suggested that a gearing limit should be imposed on collective investment schemes.[18]

6.8 *The case against borrowing controls.* Controlling the ability of scheme operators to borrow against the scheme assets could limit the kinds of schemes available to investors. There will be some projects, for example private infrastructure projects such as power stations, that would not be able to be undertaken by a

15. See para 7.21.
16. ASC Policy Statement 16 para 17.
17. In NSW and WA the borrowing limit is fixed such that total liabilities must not exceed assets by more than 3:1: *Trustee Companies Act 1964* (NSW) s 29(2), *Trustee Companies Act 1987* (WA) s 29(2). In Tasmania and Victoria the total assets to liabilities ratio cannot exceed 1:1: *Trustee Companies Act 1953* (Tas) s 17A(2), *Trustee Companies Act 1984* (Vic) s 31(2).
18. eg MLC Investments Limited *Submission* 22 November 1991; IFA *Submission* 8 April 1992.

collective investment scheme unless the scheme could borrow. Such a restriction would also be inconsistent with the private nature of collective investment schemes. The proponents of this view suggest that, instead of restricting borrowing, the law should require the borrowing policy of each scheme to be disclosed. Investors who do not wish to invest in a geared scheme can invest accordingly.[19]

Proposal and submissions

6.9 DP 53 accepted that, on balance, the arguments in favour of a limit on borrowings by collective investment schemes were more persuasive than those against borrowing controls. It proposed that collective investment schemes should be prohibited from borrowing funds in excess of 10% of the gross value of the assets of the scheme unless the borrowing was to provide liquidity to the scheme to enable the scheme to meet redemption requests.[20] A number of submissions supported a comprehensive restriction on borrowings.[21] Others argued that the restriction may not be appropriate for all schemes.[22] In particular there was concern that such control would stifle the development of schemes for financing the construction of infrastructure.

> The proposal to prohibit borrowing funds in excess of 10% of the gross value of the assets of collective investment schemes will effectively eliminate the use of limited partnerships and unit trusts as suitable structures for private infrastructure projects and property syndicates.[23]

Recommendation

6.10 While for the many large mass-marketed collective investment schemes a limit on borrowings is appropriate, there are some kinds of collective investment schemes, such as infrastructure projects, for which a borrowing limit would be entirely inappropriate. The operator of such a scheme should be permitted to borrow on behalf of the scheme an amount in excess of 10% of the gross assets of the scheme. It should be required, however, to indicate clearly that the scheme is a geared scheme. The Review therefore **recommends** that scheme operators should not be allowed to borrow on behalf of the scheme more than 10% of the gross assets of the scheme unless the name of the scheme includes the word 'geared', or some other word approved by the ASC that indicates that it may have liabilities for borrowings, and the maximum permitted level of borrowing of the scheme is disclosed in any prospectus issued by the scheme operator. Schemes not so named should not be permitted to borrow an amount equal to more than 10% of the gross

19. T Valentine *Submission* 5 November 1992; Property Resources *Submission* 20 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992; ASCPA & ICAA *Submission* 15 February 1993; Australian Film Commission *Submission* 7 January 1993.
20. Proposal 9.2.
21. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; MLC Investments Limited *Submission* 18 December 1992; St George Funds Manager Limited *Submission* 18 December 1992.
22. Mercantile Mutual Holdings Limited *Submission* 16 December 1992; Attorney-General's Department *Submission* 21 December 1992; T Valentine *Submission* 5 November 1992; Macquarie Investment Management Limited *Submission* 24 November 1992.
23. Property Resources *Submission* 20 November 1992.

assets of the scheme. Borrowing should be defined broadly to include not only loans and credit arrangements but guarantees, indemnities and other forms of contingent liability.

Valuation practices

The role of valuation

6.11 The value of the assets of a collective investment scheme is of vital importance to an investor. It determines the value of his or her investment in the scheme. Changes in the value of a scheme's assets change the value of each investor's investment. They also change the value at which investors in the scheme can redeem their investments. The methods used to ascertain these values are, therefore, particularly important. In collective investment schemes where all or most of the assets are traded in a market like the stock exchange or the commercial bank bill market, the value of the assets of the scheme is assumed to be the sum of the values quoted in those markets. The exit value of an investor's interest in the scheme is determined by deducting the scheme's exit charges from the value of the investor's share of the total investment pool. Schemes in which none or very few of the assets are traded in a market, on the other hand, will need to obtain an estimate of the market value of the scheme's assets before an appropriate redemption price can be calculated. The rapid collapse in the estimated value of the assets held by unlisted property trusts in 1991 and 1992 suggests that there may be some weaknesses in the methods used to estimate the value of the assets of those kinds of schemes.

Unlisted property trusts and valuation

6.12 The methods used to value the assets of unlisted property trusts were reviewed by the ASC following the freeze on redemptions from those trusts announced by the federal Government in July 1991. The ASC acknowledged in its policy statement on property trusts that

> the proper valuation of trust assets is crucial to the equitable treatment of unit holders given that valuations determine unit value in relation to new unit issues and buy-back and redemption of units.[24]

The ASC increased the frequency of required valuations from at least once every three years to once every year. It imposed a requirement on the trustee of each scheme to commission a new valuation of the assets of the scheme if the trustee or the manager is of the opinion that it is in the best interests of unitholders to do so. The ASC also required valuations of properties in a portfolio to be staggered to keep portfolio valuations more current and required that the instructions to the valuer be disclosed. The trustee is now required to instruct the valuer as to the method to be used to value the scheme's assets.[25] These requirements are in addition to the previously existing regulations which imposed requirements on trustees

24. ASC Policy Statement 16 para 16.
25. ibid.

- as to the appointment of an independent valuer with adequate experience[26]
- relating to the method of valuation[27]
- not to use the same valuer for more than two consecutive valuations.[28]

The Review's concerns

6.13 The changes to unlisted property trust valuation procedures introduced by the ASC addressed many of the concerns expressed at the time by industry commentators. However, some valuation practices adopted in recent times by unlisted property trusts and other collective investment schemes investing in assets that are not traded in a well developed market do not allow an accurate value for the assets of a scheme to be determined. In particular, the 'on-completion' basis for valuing the assets of collective investment schemes involving the construction of commercial buildings or other infrastructure projects is inappropriate for calculating the value of the scheme's assets, unless the investors in the scheme are not entitled to redeem their investments until completion. DP 53 sought comment on these concerns and suggestions to improve the accuracy of the values ascribed to the assets of schemes where a market price for the assets has to be estimated.[29]

Comments in submissions

6.14 Several submissions suggested that a solution to the problem lay in the adoption of standard industry wide valuation principles.[30] One submission, while supporting the use of independent valuers, was less hopeful that these principles would eliminate valuation problems.

> There seems to be no solution to the valuation problem. Valuations not based on market prices have been found to be inaccurate. Nevertheless, some independent valuation is required to prevent managers from inflating the values of their investments.[31]

Not surprisingly, real property was seen to be the most problematic asset to value, reflecting the concern with property trust valuations existing at the time this review commenced. One submission made quite detailed suggestions as to how to deal with the issue of real property valuations. The submission recommended

- the valuation of properties which are 'core' assets on the basis of their future earnings potential
- discounted cash flow to be used to value real property
- discount rates used in valuations to be disclosed
- a standard model to be used by valuers to generate discounted cash flow estimates

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26. Corporations Regulations reg 7.12.15(5)(b), (c).
27. Corporations Regulations reg 7.12.15(5)(d), (e).
28. Corporations Regulations reg 7.12.15(5)(f).
29. Issue 9A.
30. Macquarie Investment Management Limited *Submission* 24 November 1992; Arthur Robinson & Hedderwicks *Submission* 16 December 1992; Hall Chadwick *Submission* 21 December 1992.
31. T Valentine *Submission* 5 November 1992.

- 'non core' real property which is to be disposed of in the next twelve months should be valued by applying a discount or a premium to the discounted cash flow valuation.[32]

Recommendation

6.15 The Review considers that the existing rules relating to valuations should continue, but as requirements imposed by the Corporations Law, not as covenants. In addition, it **recommends** that, as a minimum, all the relevant assumptions and discount rates used in valuations of scheme property and the other instructions given to valuers should be disclosed to investors in collective investment schemes in the annual report. The Review does not consider it appropriate to make a recommendation that prescribes a particular approach to valuation such as discounted cash flows. It **recommends**, however, that the methods, for example, discounted cash flow, which valuers should be allowed to use should be the subject of a further review by the ASC and industry representatives.

Valuation and secondary markets — no recommendation

6.16 DP 53 asked whether, if a secondary market was established for the units in collective investment schemes, the assets of a scheme should have to be revalued if the market price of units in the scheme moved by more than a prescribed percentage in any fixed period.[33] Some submissions supported the proposition that assets of collective investment schemes should be revalued in such circumstances.[34] Other submissions opposed such a requirement.[35] The Review accepts that the market price of interests in a collective investment scheme, the underlying assets of which have estimated values, may fluctuate above and below the actual value of the assets of the scheme. This may reflect market sentiment as well as factors that had not been taken into account in determining the estimated value. Accordingly, the Review makes no recommendation relating to mandatory valuations of assets of collective investment schemes listed on a secondary market.

External auditors

Appropriate role of external auditors

6.17 The Review envisages that the external auditor of a collective investment scheme, appointed by the operator, will play an important role in ensuring compliance with the law and the constitution of each scheme. Auditors of banks play a key role in checking adherence to prudential standards determined by the Reserve Bank of Australia. A similar role should be conferred on external auditors of collective investment schemes. The external auditor will often be well placed to

32. Lend Lease Property Funds Management Limited *Submission* 18 December 1992.
33. Issue 9B.
34. Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; TCA *Submission* 17 December 1992.
35. T Valentine *Submission* 5 November 1992; Australian Institute of Valuers and Land Economists (Inc) *Submission* 8 December 1992; Mercantile Mutual Holdings Limited *Submission* 16 December 1992.

check adherence to compliance measures and to detect possible breaches. The accounting professional bodies agree.[36] The Review **recommends** that scheme operators should be required to provide the ASC with an annual certificate prepared by the external auditor stating that, in the auditor's opinion, the operator is giving effect to the compliance measures imposed by the Commission[37] as a condition of the operator's licence.[38] A copy of that certificate should be included in the annual report. The accounting professional bodies support these recommendations.[39] The auditor would not be under a duty to assess these compliance measures against 'best practice' principles.

External auditors to report

6.18 ***The reporting role of external auditors.*** Company auditors must draw breaches of the Corporations Law to the attention of the ASC.[40] They are given protection from civil liability when doing so.[41] Further, company auditors may only resign with the consent of the ASC.[42] The auditor of a prescribed interest scheme must report periodically to the manager whether the accounting and other records of the scheme comply with the relevant provisions of the Corporations Law.[43] DP 53 proposed that similar provisions should apply to external auditors of collective investment schemes, namely, that they should be obliged to report to the regulator

- any breach or suspected breach of the obligations imposed on the operators of collective investment schemes, or of any statutory or regulatory requirements
- a breach of the scheme constitution that comes to their notice in the course of dealing with or auditing a collective investment scheme.[44]

It also proposed that external auditors should receive appropriate protection for the contents of these reports or any other communications, formal or otherwise, they may have with the regulator. Submissions supported the Review's proposals.[45]

36. ICAA *Submission* 30 March 1993. It takes the view that auditors are ideally placed to form an opinion on compliance issues. The Review notes the work of the AASB in developing more rigorous and uniform accounting standards, and the impact of quality assurance programs being implemented by the professional accounting bodies. These developments would also impact on the auditing of collective investment schemes.
37. And agreed to by the directors of the operator.
38. An auditor would be liable only for losses resulting from negligently providing such a certificate.
39. ICAA *Submission* 30 March 1993.
40. Corporations Law s 332(9), (10).
41. Corporations Law s 1289.
42. Corporations Law s 329 (6). This is designed to protect auditors from manipulation by directors and to protect shareholders where an auditor wishes to resign rather than conclude a difficult audit. The ASC has issued a policy statement covering the circumstances that will influence it in granting consent: ASC Policy Statement 26.
43. This follows from Corporations Regulations reg 7.12.15 (6)(c).
44. Proposal 11.8.
45. eg TCA *Submission* 17 December 1992; Hall Chadwick *Submission* 21 December 1992.

6.19 ***Recommendation.*** The Review considers that effective ASC surveillance and enforcement will be enhanced by external auditors immediately notifying the Commission of possible malpractice. The Lavarch Report recommended that company auditors should be obliged to report to the ASC where they have 'reasonable grounds to suspect' any breach of the Corporations Law.[46] The Review **recommends** that external auditors of collective investment schemes should be subject to an obligation to report to the ASC where they have any reasonable grounds to suspect a breach of the law or the scheme constitution. An external auditor who communicates with or makes any report to the ASC, whether obligatory or otherwise, should have qualified privilege similar to that provided under Corporations Law s 1289. The Review also **recommends** that collective investment scheme auditors should only be able to resign or be removed in accordance with the procedure under the Corporations Law s 329.

6.20 ***Notifying the scheme operator.*** DP 53 asked whether an external auditor should be required to draw a possible irregularity to the attention of the scheme operator prior to, or at the same time as, notifying the regulator. It proposed that this should not be compulsory as it may impede the regulator's ability to respond quickly. There was some debate in the submissions on this matter.[47] The Review has concluded that, consistently with the principles governing company auditors, an external auditor of a collective investment scheme should not be required to provide any report to the scheme operator. This may be left to the discretion of the auditor.

46. House of Representatives Standing Committee on Legal and Constitutional Affairs *Corporate Practices and the Rights of Shareholders* November 1991, recommendation 18. This recommendation, which was supported by the accountancy bodies, would require an amendment to the Corporations Law s 332(10).

47. Macquarie Investment Management Limited *Submission* 24 November 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; MLC Investments Limited *Submission* 17 December 1992; St George Funds Manager Limited *Submission* 18 December 1992; ASCPA & ICAA *Submission* 15 February 1993.