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EDITORIAL SUMMARY

[691] BCLB 15: Dr Marcel Fernandes

In this edition, Robin Bowley discusses ASIC's recently released review of the Australian custodial sector, Report 291 *Custodial and depository services in Australia*. Custodial and depository services involve the holding of financial products (or beneficial interests in them) other than by a trustee of a registrable superannuation entity or by a holder of the assets of a registered managed investment scheme. ASIC outlined recommendations for best practice but stated that these did not require novel regulation. Instead, ASIC outlined six key risks for responsible entities and AFSL clients (for example, when assets are held outside of custodial arrangements) and six key risks for custodians (for example, when clients' assets are held in a single omnibus account). Relatedly, the Parliamentary Joint Committee report into the collapse of Trio Capital was also recently released. The report found that there were "expectation gaps" between the legal duties of financial sector gatekeepers, including custodians, in comparison with public expectations of their roles and responsibilities. In particular, it found that custodians have a more limited role in management investment schemes than is often assumed. For example, a custodian is a bare trustee of the assets it holds and merely follows the instructions of the relevant responsible entity. A custodian does not provide a further level of supervisory protection for investor's funds; rather, its function is analogous to a banking service. Accordingly, the report found that the term "custodian" may not be entirely appropriate and suggested the term "Manager's Payment Agent" instead, although the Australian Custodial Services Association cautioned against that change.

In *Australia DIS Pty Ltd v Deputy Commissioner of Taxation* [2012] VSC 281; BC201205059, the issue was whether a statutory demand was defective if the Commissioner's demand claims a single total on a running balance account deficit without particularising the components of the debt. The court held that the constituent parts of the debt did not have to be particularised for the Commissioner's statutory demand to be valid.

In *Australian Executor Trustees Ltd v Provident Capital Ltd* [2012] FCA 728; BC201205020, the issue was whether a receiver should be appointed where a company had not yet defaulted on debentures it had issued, in circumstances where the company was not going to meet all its obligations in the next twelve months. Justice Rares held that, despite the possible harm caused to the company by the appointment of the receiver, there did not need to be a default before a receiver could be appointed under s 283HB CA to protect the company's creditors, in particular the debenture holders.

ARTICLES

[692] ASIC review of the custodial and depository services sector

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In light of the GFC, there has been increased scrutiny on the roles and responsibilities of financial sector "gatekeepers".¹ The report of the Parliamentary Joint Committee into the collapse of Trio Capital released in May 2012 has highlighted some significant "expectation gaps" between the legal duties and public expectations of the roles and responsibilities of these gatekeepers, including custodians. ASIC also released Report 291 *Custodial and depository services in Australia* on 5 July 2012, outlining its two-phased review of the Australian custodial industry between 2009 and 2011, identifying a number of risk issues for custodians and suggesting good practices to manage these risks.

Regulation of the Australian custodial sector

The term "custodial or depository service" is defined in s 766E of the Corporations Act 2001 (Cth) ("CA"), and refers to the holding, in certain circumstances, of financial products or a beneficial interest in financial products (other than as a trustee of a registrable superannuation entity or as a holder of the assets of a registered managed investment scheme). In connection with their business of holding financial products, a custodian may provide additional services, such as trade settlement, reconciliations, fund accounting, unit pricing and reporting. Custodians will generally require an AFS licence authorising dealing (unless they do not deal in financial products).²

ASIC Regulatory Guide ("RG") 166 *Licensing: Financial Requirements* sets out the minimum financial requirements that a custodian should satisfy (except if regulated by APRA). Importantly, an entity providing a custodial or depository service, other than incidental to the provision of another financial service provided by it or a related body corporate that is not an investor directed portfolio service, should at all times have net tangible assets ("NTA") of \$5 million.³ The minimum NTA requirement is intended to ensure that the custodian has sufficient financial resources to operate compliantly, meet operational liabilities and provide for an opportunity for an orderly winding-up of a custodian's business in order to prevent client loss: see RG 166.84.

Specific AFS licence conditions are imposed on licensed custodians in relation to their licensed business and on responsible entities ("REs") in relation to scheme property. ASIC RG 133 sets out ASIC's guidance on operational standards in relation to the holding of scheme property. Compliance with RG 133 is a condition of a custodian's AFS licence and an RE's AFS licence. If an RE uses a custodian, RG 133 requires that the compliance plan for the registered scheme set out the measures to ensure that members of the scheme are protected from the possible risks arising from the custodial arrangement.⁴

In addition to their obligations under the CA, while APRA does not have direct regulatory responsibility for custodians, it does have oversight of RSE licensees: Superannuation Guidance Note SGN 130.1 *Outsourcing*.⁵ Furthermore, entities that provide "custodial or depository services" are "reporting entities" under the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 ("AML/CTF Act") and must have an appropriate program that addresses the AML/CTF risk management requirements prescribed in the Anti-Money Laundering and Counter-Terrorism Financing Rules (No.1), including a system for detection, monitoring and reporting of suspicious matters.⁶

PJC Inquiry into the Collapse of Trio Capital

The Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Collapse of Trio Capital ("**PJC Inquiry**") investigated the largest superannuation fraud in Australian history -- with around \$176 million in Australians' superannuation funds lost or missing from two fraudulent managed investment schemes, with Trio Capital as the RE for both schemes.⁷

The PJC Inquiry identified some significant "expectation gaps" between what is expected of auditors, custodians and research houses, and what they are actually responsible for doing.⁸ Relevantly, it noted that custodians appear to have had a limited role in managed investment schemes of the kind conducted by Trio and by many legitimate financial services providers.

The custodian (in Trio's case, the National Australia Bank) does very little to protect the funds of investors. It makes no independent checks before transferring money offshore. Instead, the custodian simply acts on the instructions of the RE;⁹ furthermore, they are not required to verify underlying assets in managed investment schemes, only the units in these schemes.¹⁰ The Australian Custodial Services Association ("ACSA")¹¹ explains that a custodian is generally considered to be a "bare trustee" of assets held by the custodian; the custodian will only act on the proper instructions of their client (or a party duly appointed by the client). The terms on which the custodian will act are established under a custody agreement (written contract) between it and the client.¹²

ACSA emphasises that the custodian does not (and cannot) second-guess investment decisions or override proper instructions; the custodian's role is analogous to that of a bank or credit union processing payments for its customers.

ACSA also pointed out that while the custodial function significantly reduces the risks faced by institutional investors in some areas, it does not provide protection against poor investment decisions on the part of the client or their investment manager, as exhibited in the Trio Capital collapse.¹³

Accordingly, the PJC Inquiry concluded the word "custodian", particularly when used in Product Disclosure Statements, is inappropriate, and urged ASIC to find another term, which does not give unwarranted reassurance to investors -- suggesting the term "Manager's Payment Agent".¹⁴ However ACSA has cautioned against such bold changes -- pointing out the term "custodian" is used globally, and that a name change would place Australia at odds with the rest of the world.¹⁵

ASIC's review of the Australian custodial sector

ASIC identified a total of 12 client asset risks for the industry to consider in Report 291, emphasising its recommendations for good practice reflected its current regulatory position and did not warrant the introduction of any new regulatory requirements or standards.¹⁶

First, ASIC discussed six risk issues for REs and AFSL clients to consider:

1. **Assets held outside of custodial arrangements:** ASIC reminded REs that, as set out in RG 166, under its AFS licence conditions, an RE that relies on a custodian to meet reduced NTA requirements must ensure that all scheme property (apart from certain assets and scheme property excluded under the terms of the licence) is held by the custodian.¹⁷
2. **Scheme property, specifically cash, not be held on trust:** Cash is in some cases held on deposit at the custodian rather than on trust. AFS licence conditions generally require an RE that does not have \$5 million NTA to ensure that cash be held on trust by a custodian that either meets the NTA requirements or is an eligible custodian.¹⁸
3. **High levels of operational risk and opportunities for fraud present:** ASIC noted, notwithstanding a strong compliance culture amongst custodians, a high level of operational risk and opportunities for fraud remain, such as in the continuing practice of accepting written, faxed "authorised instructions" and recommended measures to mitigate risk, including the introduction of streamlined straight-through processing procedures.¹⁹
4. **Assets and records not accurately transferred from one custodian to another on a change of custodian:** Noting the increasing consolidation within the superannuation, managed funds and custodial industries and the opportunities for fraud and "leakage" of assets and records, ASIC suggested clients conduct a review of assets and records transferred after transitions to new custodians as a matter of course.²⁰
5. **Consideration of outsourced services (particularly offshore) of the custodian in their risk management arrangements, introducing additional threats to the safety of client assets:** ASIC recommended appropriate business continuity planning and internal and external audit functions.²¹
6. **Inadequate risk management arrangements to deal with the insolvency of the custodian or sub-custodian:** While noting the risk of insolvency or termination of business by custodians in Australia should not normally be a threat to the safety of client assets, ASIC noted several risks remain, such as assets held in offshore jurisdictions that are subject to different local practices and insolvency laws.

Second, ASIC discussed six risk issues for custodians to consider:

1. **Omnibus accounts:** ASIC noted that client assets are typically held through an omnibus account in the name of the custodian or its nominee, rather than in individual accounts for each underlying client. ASIC's review underscored the existence of "client money risk" such as when a client's money is used to settle another client's obligations.²²
2. **IT systems not stable or secure from unauthorised access or use:** Custodians should remain cognizant

- of maintaining data integrity and security when outsourcing significant functions such as unit pricing (particularly offshore).²³
3. **Operational risks introduced by not upgrading systems:** ASIC found there is still a reliance on manual and disparate systems which may be out-of-date, slow and cumbersome, and that not upgrading these systems can introduce new operational risks.²⁴
 4. **Risk of ignoring or not identifying misconduct and suspected misconduct:** In addition to their reporting obligations under the AML/CTF Act and, specifically, the obligation to lodge suspicious matter reports with AUSTRAC, ASIC urged custodians, and other participants in the financial services industry, to foster a whistleblowing culture and framework, where misconduct, or suspected misconduct, of clients or the custodian and its staff is reportable to ASIC under their risk management arrangements.²⁵
 5. **Failure to investigate valuations that are inaccurate and potentially fraudulent, or raise suspicious matters with AUSTRAC/ASIC:** ASIC urged custodians to report such suspicious matters to AUSTRAC or ASIC as appropriate.²⁶
 6. **Failure to report significant breaches in investment administration areas:** ASIC considered it good practice for custodians to develop a culture of transparency, including risk management strategies, and report incidents and breaches to ASIC across all their business (not limiting these to activities outside the scope of their AFS licence and breach reporting requirements).²⁷

1 In his first external speech as the current ASIC Chairman Mr Greg Medcraft explained the term "gatekeepers" as follows: "Gatekeepers' are the intermediaries who provide or assist in providing investors and financial consumers with the information they need to navigate the financial world. Gatekeepers collect, evaluate, advise on and endorse information about companies, assets and investments. They are involved at all parts of the value chain. They include financial advisers, lawyers, auditors, custodians, actuaries, research houses, credit rating agencies and independent experts, and those involved in the product approval process" - Speech to the Financial Ombudsman Service National Conference 2011, Melbourne Convention and Exhibition Centre, 2 June 2011, p 4.

2 ASIC Report 291 *Custodial and Depositary Services in Australia*, July 2012, para 41.

3 Ibid, para 51.

4 Ibid, para 55-56.

5 Ibid, para 43.

6 Ibid, para 65.

7 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the Collapse of Trio Capital*, May 2012, p xvii.

8 Ibid, p xxii.

9 Ibid, p xxiii.

10 Ibid, para 5.56.

11 ACSA is the peak industry body representing members of Australia's custodial and investment administration sector -- www.custodial.org.au.

12 ACSA Institutional Investor Services, "How custodians support Australia's wholesale superannuation and investment sectors" 2012, p 8.

13 Ibid, p 9.

14 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the Collapse of Trio Capital*, May 2012, paras 7.43-7.44.

15 Australian Custodial Services Association, *ACSA welcomes opportunity to further understanding of custodian role: Australian custodian*

body responds to PJC report, 23 May 2012, accessed 30 July 2012, www.custodial.gov.au.

16 ASIC Report 291 *Custodial and Depositary Services in Australia*, July 2012, para 5.

17 *Ibid* , paras 81-84.

18 *Ibid*, paras 85-88.

19 *Ibid*, paras 89-94.

20 *Ibid*, paras 95-97.

21 *Ibid*, paras 98-99.

22 *Ibid*, paras 109-115.

23 *Ibid*, para 116.

24 *Ibid*, paras 117-119.

25 *Ibid*, paras 120-121.

26 *Ibid*, paras 122-125.

27 *Ibid*, para 126.

RECENT CASES

[693] Company seeks orders to extend the time for holding a member-requisitioned meeting

Ben Langford

Woolworths Ltd v GetUp Ltd [2012] FCA 726; BC201205060 (6 July 2012, Yates J)

[CA ss 249D, 249P, 1322]

Federal Court finds no injustice in granting an extension to the time for holding a member-requisitioned general meeting to coincide with the scheduled AGM.

Facts

On 25 June 2012, GetUp and 209 other current members of Woolworths sought to requisition a meeting of members and issue a statement on their behalf, seeking a change to Woolworth's objects and purposes to exclude the ownership or operation of electronic gaming machines or the derivation of any income from those activities, with effect from 1 January 2016.

Based on the statutory periods for calling and holding a member-requisitioned meeting, Woolworths would need to call the meeting by 16 July 2012 and hold the meeting by 25 August 2012 to comply with the relevant CA provisions,