External perspective

Ongoing changes to regulatory regimes need to be understood

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Australia's financial services regulatory regime is unique and requires particular compliance and expertise from organisations seeking to operate in this market. Asset managers considering expanding into Australia will need to understand and comply with existing stringent requirements as well as the ongoing changes anticipated over the next few years.

Since the start of the North American credit crunch, there has been much questioning of the processes and systems that were supposed to prevent the kinds of corporate collapses and investment scheme defaults that have cost investors millions over the last few years.

Compared to most of the developed world, Australia has performed relatively well. We have not escaped completely unscathed from the worst of the crisis, with failures such as Storm Financial and Trio Capital posing major problems for both investors and regulators, but these have not been on the same scale as, for example, the collapse of Lehman Brothers or the Bernie Madoff scheme.

As a result of the relative stability in Australia's financial system, combined with the country's well-established superannuation system, Australia is often seen as an attractive area of expansion for overseas asset managers.

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The Australian investment landscape

Australia has one of the largest and fastest growing fund management sectors in the world, with over AU$1.9 trillion[1] in funds under management. This growth has been bolstered by Australia's government-mandated retirement scheme, superannuation, which was introduced in 1992. Currently, all Australian employees must put aside 9% of their salary into superannuation; this is set to increase gradually to 12% of salary by 2019-2020.

Australia therefore has a substantial and increasing pool of investments—by some estimates, the fourth largest in the world—which has resulted in a number of international asset managers setting up operations here.

Currently, there are over 130 investment management firms, both domestic and international, operating in Australia, as well as approximately 200 smaller hedge and boutique fund managers. The top 30 investment management firms control over 85% of the industry's funds under management.

Two-thirds of the investable funds come from wholesale investors, such as pension funds and insurance firms, and one-third from the retail investor market. The retail investment management market is dominated by large domestic institutions, with 23 out of the 30 largest retail fund managers being of local origin.

The total of these domestic companies' unconsolidated assets is almost AU$390 billion, accounting for around 90 percent of the retail market.

Therefore, while there are attractive opportunities for fund managers, the complexities of the existing regulatory regime in Australia, as well as the changes currently being made to improve investor protection, need to be understood, as the system is quite different to that used in any other country.

1 Australian Bureau of Statistics, as at 30 June 2012

Responsible Entity regime

The current Responsible Entity (RE) regime was established in Australia 12 years ago to replace an antiquated 'independent trustee' system, which itself was introduced in 1951 in response to significant investor losses arising from the failures of timber plantation schemes.

The RE regime was mandated through the Managed Investment Act, which came into force in 2000 as a new model for collective investment schemes such as managed funds.

It enhanced the concept of an 'independent trustee' by giving legislative power and responsibility to an entity whose primary objective is the protection of investors in collective investment schemes.

The RE is entrusted with the management of a collective investment scheme (including its governance and control framework) and has the ability to appoint authorised agents (for example an investment manager, administrator, custodian and registry provider) to manage the fund's affairs on a daily basis.

REs must be incorporated as Australian public companies (whether listed or unlisted), must hold an Australian Financial Services Licence (AFSL) and are required to maintain mandated levels of Net Tangible Assets (NTA).

This investor protection approach is unique to Australia. In many ways, it has proved to be a successful mechanism for market stability; nonetheless, the global financial crisis was its first real test and some aspects of the system have been found wanting.

Recent changes

Despite the relative stability of Australia's financial and regulatory environment, further changes have recently been introduced to the RE system to enhance investor protection and regulatory oversight.

Towards the end of 2010, the Australian Securities and Investments Commission (ASIC), Australia's corporate, markets and financial services regulator, released a Consultation Discussion Paper (CP140) calling for industry participants' feedback on ways to strengthen the financial resources of REs.

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Following ASIC's review of the responses received, it issued a new regulatory guide in November 2011, with the following key requirements introduced to the RE regime:

1. A requirement that REs prepare (rolling) 12-month cash flow projections which must be approved by the directors at least quarterly
2. A new NTA calculation whereby REs must hold the greater of:
   - AU$150,000
   - 0.5% of the average value of scheme property (capped at AU$5 million) or
   - 10% of the average RE revenue (uncapped)
3. New minimum liquidity levels whereby REs must hold the greater of AU$150,000 or 50% of their NTA requirement in cash or cash equivalents
4. A requirement to exclude from the NTA calculation any potential liability under any personal guarantees provided by the responsible entity
5. A requirement to exclude from the calculation of the NTA requirement any listed parent entity's eligible undertakings

A proposed solution is to ensure that smaller fund managers who are unable to adequately resource their own RE function, are obligated to use an external RE

Future changes

While these changes are worthwhile, it is unlikely that we have seen the last of the tweaks to the regulatory system in Australia. There are still discussions underway that may see additional amendments introduced over the next few years—in particular, to further strengthen Australia's regulatory environment given the increasing complexity of products and ease of global capital mobility, and to enhance Australia's position as a significant investment and trading hub in the Asia-Pacific region.

In my view, there are still three main areas that need examination. They are: potential conflicts of interest; size and resources of promoters; and complexity of investment products now being offered. In Australia, managers have the option of becoming RE of their funds themselves, or appointing a specialist external RE.

Larger managers with more extensive control environments and resource capabilities clearly have no problems managing the two roles internally, with their compliance teams completely separated from those handling the money.

However, problems can occur, and clearly have, when the people handling the money also run the RE function.

Unlike large financial institutions, small managers generally do not have adequate capabilities to establish and resource an effective in-house RE separately from those who manage the money. They are therefore more likely to become conflicted.

The answer, to me, must be to ensure that smaller fund managers that cannot resource a completely separate RE function are obliged to use an external RE.

Benefits of external responsible entities

External REs provide greater independence to the fund management value chain. They are also more likely to have stronger policies and processes to perform appropriate due diligence on potential investors and service providers so as to ensure that parties that evoke suspicion are avoided—another level of investor protection.

It only requires a relatively simple change to existing definitions in the regulations to define whether a manager is 'large' or 'small', and the latter to seek out the assistance of an external RE.

This should improve compliance and investor protection and remove the conflicts of interest that have been exposed with some in-house REs. In addition, the RE regime has benefited overseas fund managers and promoters through the reduced compliance burden of setting up their own compliance framework in Australia to meet local regulatory requirements. Overseas fund managers' operational risks and business costs can be reduced through the economies that are typically available from working within the RE's established and active compliance framework.

In summary

Specialist companies offering independent RE services, such as Equity Trustees, have processes and due diligence approaches in place which allow them to say 'no' to some of the entities wanting to set up an investment vehicle in Australia, such as Bernie Madoff and other overseas entities that have since collapsed.

Investment managers considering setting up operations in Australia should make sure they have fully considered the implications of the RE regime on their business, and have considered how best to manage the compliance, regulatory and management undertakings required of them.

To the **Point**:

- Australia has not been immune from the challenges caused by the 'North American credit crunch' and subsequent market impacts
- Regulators continue to seek ways to improve investor protection, placing a higher level of regulation on asset management companies operating in Australia
- An understanding of these requirements, as well as how they are likely to change over the next few years, is vital for any fund managers considering expanding into Australia