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Financial System Inquiry
By email: fsi@fsi.gov.au

Submission responding to the Inquiry's Interim Report observations – Frozen Funds

This Submission is a result of a request to the author from Mr. David Murray AO at the Inquiry's public forum in Sydney on 20 August 2014. At that forum, the author asked of the Inquiry what regulatory reform of managed investment funds might be made at the intersection of corporation law, trust law and contract law.

Firstly, what reforms might be made in respect of frozen ('non-viable') funds and their trustees (known as 'Responsible Entities'). Secondly, as regards these Responsible Entities, should there be a 'continuous disclosure' regime (as opposed to the current 'breach disclosure' regime). Thirdly, should there be re-evaluation of the Responsible Entities' indemnity and limitation on liability when non-viable funds continue trading. The latter begs a 'solvency'-like question of just when does a fund become 'non-viable'?

To exemplify these questions, this Submission seeks to provide publicly-available evidence on behalf of interested stakeholders in four recently frozen 'van Eyk Blueprint' managed investment funds to support the Inquiry's Interim Report observations. To be clear, this Submission does not suggest or allege any wrong doing by any person or any entity.

Terms of Reference

This Submission is confined selectively to three of the Inquiry's Terms of Reference as follows:

- No.2. Principles underpinning the development of a well-functioning financial system, namely: balancing efficiency, stability and consumer protection; how financial risk is allocated; assessing the effectiveness and need for financial regulation; and the role of financial regulators.
- No.3. Opportunities and challenges, including: international financial regulation; governance structures across the financial system and how they affect stakeholder interests.
- No.5. Regulation of the general operation of trusts to the extent this impinges on the efficiency and effective allocation of capital.

Interim Report Observations

This Submission is responding only to four of the Interim Report observations, namely:

- Stability - Corporate governance
- Consumer outcomes - Effective disclosure

- Consumer outcomes - Managed investment scheme regulation
- Regulatory architecture - Regulators' mandates and powers

Stability

Observation

To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibilities and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions,… substantial regulator focus on boards has confused the delineation between the role of the board and that of management.

- Regulators continue to clarify their expectations on the role of boards.

Consumer outcomes

Observation

The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.

- Improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.
- Remove disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery.
- Subject product issuers to a range of product design requirements, such as targeted regulation of product features and distribution requirements to promote provision of suitable products to consumers.
- Provide the Australian Securities and Investments Commission (ASIC) with additional product intervention powers and product banning powers.

Regulatory architecture

Observation

Australia generally has strong, well-regarded regulators, but some areas of possible improvement have been identified to increase independence and accountability.

- Move Australian Securities and Investments Commission (ASIC) and Australian Prudential Regulatory Authority (APRA) to a more autonomous budget and funding process.
- Conduct periodic, legislated independent reviews of the performance and capability of regulators.
- Clarify the metrics for assessing regulatory performance.
- Enhance the role of Statements of Expectations and Statements of Intent.
- Replace the efficiency dividend with tailored budget accountability mechanisms.
- Improve the oversight processes of regulators.

Observation

Regulators' mandates and powers are generally well defined and clear; …. In addition, ASIC has a broad mandate, and the civil and administrative penalties available to it are comparatively low in relation to comparable peers internationally.

- Strengthen competition considerations through mechanisms other than amending the regulators' mandates.
- Refine the scope and breadth of ASIC's mandate.
- Review the penalty regime in the Corporations Act.

Background

On 5 August 2014, Sydney-based funds manager van Eyk Research ('van Eyk') announced a 'temporary' suspension of redemptions, effective 31 July 2014 on four of its investment funds. The fund at the core of the suspension is the van Eyk Blueprint International Shares Fund ('VBISF'). The other three funds are the van Eyk Blueprint Capital Stable, Balanced and High Growth funds. Total assets involved are reported to involve some $800 million.
On 15 August 2014, the Responsible Entity of the funds, Macquarie Investment Management Limited ('Macquarie') announced a 'termination' of these funds and foreshadowed their 'winding up'.

ASIC Submission in respect of 'Frozen Funds'

At pages 223-224 of its Submission to this Inquiry, the ASIC wrote in respect of frozen funds.

At its paragraph 855, the term 'frozen fund' is defined as a registered managed investment scheme that was marketed to investors as having a right to redeem, but that right has been suspended by the responsible entity.

At its paragraph 858, responsible entities must freeze payments if the scheme ceases to be 'liquid'. Under the Corporations Act, a scheme is <u>liquid if at least 80% of its assets comprise cash,</u>

bills, marketable securities or other assets that can be realised for the market value within the period provided for in the scheme's constitution for satisfying redemption requests. Once a fund is frozen, a responsible entity may make a 'withdrawal offer' in accordance with the Corporations Act if it is in the best interests of members.

At its paragraph 859, a freeze on payments ensures that scheme members are treated equitably but the length of time that it will take to have capital returned will vary significantly from scheme to scheme.

At its paragraph 860, the ASIC made a modification of the Corporations Act to allow responsible entities to return some capital to certain members in exceptional circumstances, known as 'hardship relief'.

Submission: Further reforms are required

In the 15 March 2010 edition of Money Management, a well-known fund manager wrote an opinion piece entitled, *"It's time for investors to face the truth about frozen funds",* http://www.moneymanagement.com.au/opinion/columns/observer/the-truth-about-frozen-funds

The opinion went on to explain why it was time then to "increase the heat on the frozen funds". It was argued that "large elements of the financial services industry look on in bewilderment (at frozen funds) and are often too conflicted to … push financial institutions for proper solutions. (Additionally), Regulators have tinkered at the edges …, Platforms and planners pay lip service to the need for solutions …, and most (as with Fund managers) continue to take full fees on assets their clients can do little about. Indeed, investors are … the big losers…paying significant fees to have large chunks of their portfolios locked up in illiquid assets,… (are reduced in) flexibility to take advantage of other investment opportunities and to adopt an appropriate asset allocation in a challenging environment.…Investors (urgently) need clarity about solutions,… (in) addressing the level of distrust that (frozen funds) has generated. The industry has to find solutions now that work for investors, not themselves".

Near five years has passed, and it is submitted that "the truth" that investors have to face about frozen funds is that nothing much (of that noted above) has changed.

In the April 2011 volume of the Australian Business Law Review, lawyer Nuncio D'Angelo asked the following questions, *"When is a trustee or responsible entity insolvent? Can a trust or managed investment scheme be "insolvent"?"* (2011) 39 ABLR 95.

D'Angelo wrote that "there is abundant case law on the meaning of 'insolvency' in relation to companies. Insolvency is the gateway for a range of consequences under the *Corporations Act 2001* (Cth) for a company and its stakeholders, particularly its directors and creditors. However, while a trust or managed investment scheme may be described as 'insolvent' in certain contexts, it cannot be an insolvent person under the *Corporations Act*; the analysis for the purposes of the Act must be conducted at the level of the trustee or responsible entity, although the viability of the trust fund or scheme is relevant in that analysis. At this point, the

matter becomes quite complicated, due to the arcane nature of trusts and the resultant complexities when they are used as business vehicles. …the challenges facing directors and creditors (are) in ascertaining if and when a trustee or responsible entity has become insolvent, and what it means for a trust or scheme to be 'insolvent' – matters on which there is a surprising lack of guidance. …".

D'Angelo went on to identify past cases that dealt with "hopelessly insolvent" responsible entities but concluded that very little consideration by the authorities has been made of how "viability" of a fund is to be taken into account in assessing the solvency of the responsible entity.

Evidence regarding the Van Eyk Blueprint International Shares Fund

The 'temporary' suspension of redemptions of the four van Eyk Blueprint funds and the subsequent announced 'termination' of these funds has been well canvassed in the press. The Australian newspaper serves as a good example of the local media coverage, as follows:

(18 August 2014) van Eyk forced to suspend redemptions

http://www.theaustralian.com.au/business/van-eyk-forced-to-suspend-fund-redemptions

(21 August 2014) Further strife hits van Eyk

http://www.theaustralian.com.au/business/companies/further-strife-hits-van-eyk

(26 August 2014) Disclosures behind van Eyk funds may shed light

http://www.theaustralian.com.au/business/wealth/disclosures-behind-van-eyk-funds-may-shed-light

Also telling is this report in today's Australian Financial Review…

(26 August 2014) AWI wants answers from van Eyk

http://www.afr.com/p/business/companies/awi_wants_answers_from_van_eyk

Across the Tasman, the coverage has been more pointed, exemplified as follows:

(8 August 2014) Kiwi fund manager in global stoush

http://www.stuff.co.nz/business/industries/10362908/Kiwi-fund-manager-in-global-stoush

(13 August 2014) Behind the freeze

http://www.stuff.co.nz/business/opinion-analysis/10376605/Behind-the-freeze

Related and intertwined coverage extends back in history many years and even purportedly suggests that a number of persons and entities may have associations which could be of interest to stakeholders today, as follows:

(25 September 2012) van Eyk

http://pgcnz.blogspot.com.au/

http://pgcnz.blogspot.com.au/search/label/Van%20Eyk

(13 July 2012) Torchlight securities

http://pgcnz.blogspot.com.au/search/label/torchlight%20securities

(31 January 2012) Baker Street Capital, Perelman, Kerr

http://pgcnz.blogspot.com.au/2012/01/baker-street-capital-v-kerr-stupid-is.html

http://pgcnz.blogspot.com.au/search/label/perelman

(15 July 2010) van Eyk's new backer

http://investmentmagazine.com.au/2010/07/financial-firepower-why-van-eyks-new-backer-can-fuel-lasting-growth/

(1 April 2008) Macquarie backed ArteFact Partners

http://investmentmagazine.com.au/2008/04/getting-its-shorts-right-boosts-macquarie-backed-artefact-2/

(May 2007, as reported in Investment & Technology magazine)
Macquarie backs ArteFact Partners with some $60 million, including its fund terms

www.artefactpartners.com/media/connexus

Stylised Diagram

Attached is a first draft 'stylised' diagram that brings together both various publicly-available documents and the above-mentioned media reports. As the matter concerning the van Eyk funds is very fresh and ongoing, it may be the case that further information becomes public to add to, contradict, and/or shed further clarity.

Conclusion & Submissions

It appears from official manager documents for the van Eyk Blueprint International Shares Fund ('VBISF') that this fund (reportedly with total assets circa $100 million) invested some $30 million into an ArteFact Partners (Global Opportunities) fund from about July 2012. It is noted that investors were told, as of 30 September 2013, in the relevant van Eyk fund factsheet that "the allocation to ArteFact Global Opportunities was removed and placed into the US S&P500 index". It appears that the allocation was 'equitised' with index futures. The former assertion of 'removal' appears to not have happened, and the VBISF appears to be still invested today in the ArteFact fund. Hence, the very public "stoush" reported between van Eyk and Artefact Partners. Given however that Macquarie reportedly 'seeded' ArteFact Partners from 2006/07, it might be suggested that its 'collective corporate memory' could or should have known that the ArteFact fund has terms that include a two-year 'lock-up' of investors' money. Therefore, when van Eyk Research advised Macquarie (as responsible entity) to invest the VBISF into the ArteFact fund, it might be suggested that Macquarie could or should have considered the impact of 'illiquidity scenarios' on the 'continuing viability' of the VBISF.

It is submitted that the recent matter of the van Eyk funds exemplifies a need to consider regulatory reform in respect of frozen ('non-viable') funds and their trustees (known as 'responsible entities'). As regards the responsible entities, it is submitted that there should be a 'continuous disclosure'-like regime (in addition to the current 'breach disclosure' regime). Furthermore, it is submitted that there should be re-evaluation of the responsible entities' indemnity and limitation on liability where 'non-viable' funds continue accepting investors' applications. The latter of course begs a 'solvency'-like question of just when does a fund become 'non-viable'.

Thank you for this opportunity to make a submission.

Yours sincerely

Greg Hogan

Attachment: first draft 'stylised' diagram