JONES DAY

MAY 2006

ASIC'S POSITION ON CONFLICTS OF INTEREST AND ITS IMPACT ON RELATED-PARTY FUNDS MANAGEMENT STRUCTURES

On 19 April 2006, the Australian Securities & Investments Commission ("ASIC") released a discussion paper on the management of conflicts of interest in the financial services industry.[1] The paper sets out a number of hypothetical scenarios in relation to real or perceived conflicts of interest as a means of explaining ASIC's view on how these conflicts should be managed. While attention on the discussion paper has been diverted by ASIC's decision to put a stake in the ground on conflicts arising from investment banking mandates and proprietary trading, several of the hypothetical scenarios mentioned in the paper relate directly to funds management structures. These hypotheticals demonstrate ASIC's thinking that there are conflicts of interest inherent in a number of domestic fund structures that involve engaging related-party service providers as managers or advisors.

ASIC could be criticised for coming to the table too late in raising regulatory concerns on these issues at this stage in the development of the Australian funds management industry. However, the focus in the discussion paper on conflicts, funds and related-party service providers might sound as a warning bell to investment houses whose business involves establishing satellite funds where these conflicts are present.

CORPORATIONS ACT POSITION

The Corporations Act includes several provisions that regulate conflicts of interest for responsible entities ("REs") of registered schemes and their officers.

For example, an RE of a registered scheme, in exercising its powers and carrying out its duties, must "act

1. "Managing conflicts of interest in the financial services industry", ASIC Discussion Paper, April 2006.

in the best interests of its members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests".[2] A similar duty is imposed on officers of a registered scheme.[3] A financial services licensee is also required to have in place adequate arrangements to manage conflicts of interest which may arise in relation to activities it undertakes in providing its financial services business.[4]

ASIC'S PREVIOUS POLICY POSITION

In August 2004, ASIC issued Policy Statement 181 (Licensing: Managing conflicts of interest), which outlined the Commission's general policy approach to the duty of financial services licensees to manage, control, avoid and disclose conflicts of interest so as to ensure compliance with a licensee's obligations under the Corporations Act.

In the media release that accompanied the release of the discussion paper, ASIC said that following the consultation period, the hypotheticals referred to in the paper would be incorporated into PS 181.

ASIC'S DISCUSSION PAPER

Related-Party Managers and Service Providers to REs. The first hypothetical scenario that ASIC examines relates to a fund manager and responsible entity (Peacock) which has appointed its parent company (Honeybee) to market and provide asset management services to the fund. Peacock's fund performs badly because of poor asset selection by Honeybee, but owing to the "ownership and governance structure" of the RE and its manager, Peacock cannot terminate the relationship with Honeybee and appoint another asset manager.

ASIC argues that corporate group structures similar to the one to which Peacock and Honeybee belong involve "inherent conflicts of interest". An example of such a structure is where it is customary for fund managers and REs to use members of the group as service providers. ASIC's point is that regardless of group structures, an RE must act in the best interests of members at all times. ASIC implies that an RE whose fund is underperforming because of the level of service provided by a manager (Peacock) would not be acting in the best interests of its members unless it terminated the incumbent manager (Honeybee) and appointed a new one.

At a more specific level, ASIC believes that an RE has the following duties in respect of acting in the best interests of members when it comes to appointing and monitoring the performance of managers or other service providers to the fund:

- A duty to ensure that the service providers it selects are "appropriate" and that it is "reasonably able to supervise them".
- A duty to ensure that the fees paid, and other benefits provided, to service providers (including interests in the fund that are issued at a discount) are "competitive" and reflect "value for money" for investors in the fund.
- A duty to assess and consider whether all asset management recommendations are in the best interests of fund investors before acting on them.

Embedded RE Termination Fees. The second hypothetical scenario that ASIC examines relates to an RE of a registered managed investment scheme (Cougar) that is "embedded" as RE in the constitution of a fund to which it has been appointed (Bigfee), and must be paid a one-off termination fee of 3.5 percent of funds under management if it is removed. The termination fee is disclosed in the Product Disclosure Statement for the Fund. Cougar is a wholly owned subsidiary of a holding company that is also the promoter of the Bigfee fund.

ASIC argues that, notwithstanding the disclosure in the PDS, the Bigfee Group has set up a scheme under which its interests will prevail over the interests of scheme members because the scheme entrenches its wholly owned subsidiary

2. Section 601FC(1)(c).
3. Section 601FD(1)(c).
4. Section 912A(1)(aa).

(Cougar) as RE and imposes a pecuniary penalty if scheme members want to terminate the RE's services.[5]

OBSERVATIONS ON THE ASIC HYPOTHETICALS

Related-Party Service Providers. The common thread between both hypotheticals is that the manager (in the first scenario) and the RE (in the second scenario) are related parties of the corporate group in which the fund operates.[6] ASIC's general position on this issue appears to be twofold. First, being a related party does not excuse an RE of a registered scheme or its officers from ensuring that they comply with their respective duties under the Corporations Act to act in the best interests of members and give members priority when it comes to a conflict between its own interests and those of its members. Put another way, while its own interests may be best served by acting in the wider interests of the group of which the RE is a part, this cannot be at the expense of the interests of members. Second, these issues are not as prevalent or pronounced where service providers or, indeed, REs themselves (to take the Cougar example) are arm's length to either the corporate group of which the RE is a member or the promoters of the fund to which the RE is appointed.

Overlap With Related-Party Rules. Although not mentioned in the ASIC discussion paper, there is an interesting overlap between conflict-of-interest and related-party transaction issues in the two hypothetical scenarios. In the first hypothetical, for example, it is without doubt that the entry into the management agreement between Peacock (the RE) and Honeybee (the manager) would have involved Peacock giving Honeybee a financial benefit. Even if this financial benefit was permitted under the related-party transaction rules that apply to registered schemes under the Corporations Act or in fact was approved by the scheme's members, section 230 of the Corporations Act makes it clear that a director is not relieved from any of his duties under the Act or his fiduciary duties at large merely because a transaction is authorized under the related-party rules. This would, of course, extend to an RE's director's duty in the case of a registered scheme to act in the best interests of members and give priority to these interests in the event of a conflict.

Accordingly, directors of an RE of a registered scheme should be careful not to be lulled into a false sense of confidence that because the related-party rules permit entry into a transaction that involves the RE giving a financial benefit to a related party, there is no conflict of interest. The converse is actually the case: namely, authorized related-party transactions may still be problematic or prohibited because, by their very nature, they do give rise to a conflict of interest.

Corporate Group Issues. The potential for related-party transactions to raise inherent conflict-of-interest issues may be more pronounced in some corporate groups than others. Factors that may increase the risk of conflict-of-interest issues arising include whether it is customary for an RE to use service providers that are related parties or members of the same group, whether related-party service providers are appointed as an automatic function of new fund establishment and structuring mandates, and whether related-party service providers are appointed for multiple service

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5. There are a number of examples of embedded termination fees for the removal of responsible entities prevalent in Australian funds. One example is the Becton Diversified Property Fund, which was launched in February 2006. According to the Product Disclosure Statement for the Fund, the responsible entity is entitled to be paid a "removal fee" of 2 percent of gross assets (plus a cash kicker based on value of gross assets) if it is removed as manager of the fund. One of the scenarios not discussed by ASIC is where the conflict of interest may be less direct, such as where an RE has a right under the fund's constitution to agree a "removal fee" with any incoming RE that replaces it, and treat the removal fee as being to its own account.

6. ASIC is not the first to raise related-party transactions in managed funds as an area rich with conflict-of-interest issues. In October 2005, Corporate Governance International ("CGI") released a research paper into corporate deficiencies in the ASX listed trust sector. CGI concluded that management, advisory and other services provided by the promoters of listed trusts or their associates were related-party transactions that, at a minimum, created the potential for substantial conflict between the interests of investors in listed trusts and the interests of the promoter or manager. CGI also noted in this context the duties of REs and officers under the Corporations Act to act in the best interest of investors and, in the event of a conflict, to give priority to the investors' interests.

roles in respect of which the service providers are entitled to a fee (*i.e.*, advisory, management and promotion fees). The nature, role and function of the RE itself may also accentuate the potential for conflicts of interest. For example, it is not uncommon for REs to be appointed the responsible entity of multiple funds that operate in or are associated with the same single corporate group. This adds another layer of complexity to dealings engaged in by the RE in different capacities within its corporate group.

The hypothetical scenarios presented by ASIC press home the fact that conflict-of-interest issues between related parties can actually be entrenched through structuring decisions taken at the time funds are established (*i.e.*, the appointment of a related party of the RE as a manager), and are not necessarily the exclusive domain of decisions made by REs once the fund is up and operating. It follows that conflict-of-interest issues may now be worth taking into account at the structuring and planning stage for funds, not just after the funds have raised monies from investors.

Disclosure Not a "Cure-All". The embedded termination fee in the Bigfee hypothetical was disclosed in the Product Disclosure Statement. However, ASIC makes it clear in its discussion paper that disclosure alone will rarely be sufficient to manage a conflict of interest and that disclosure needs to be combined with internal controls to ensure effectiveness.[7] This is not to say that disclosure, when combined with other steps to help manage the conflict, will not be effective in managing conflicts of interest. Market practice in Australia has been to deal with related-party and conflict issues generally in disclosure documents. This should be compared with market practice in the United States, particularly in relation to products and funds established by investment houses or financial intermediaries, where extensive conflict-of-interest disclosures are commonplace.[8]

Also left unmentioned in the ASIC hypothetical is the role of informed consent from investors in "blessing" what would otherwise be a conflict of interest. If ASIC's notion of what constitutes a conflict of interest is based on general law principles, it may be arguable, for example, that if the payment of a termination fee to an RE is embedded in the fund's constitution, then doing so—when combined with appropriate disclosure in a disclosure document—may be the market equivalent of having sought the informed consent from investors to pay the termination fee notwithstanding any conflict of interest.

Registered Schemes. One interesting point in relation to the statutory duties of REs and their officers to act in the best interests of members and to give members' interests priority in the case of a conflict of interest is that they apply only to REs of registered schemes. While on some occasions there is no choice but for a fund to be a registered scheme, in other cases there may be an option to be either a registered or unregistered scheme (particularly if the fund is unlisted). If a group structure or manager and advisory appointments, for example, raise an inherent conflict of interest, this alone may be a good reason to consider establishing a fund as an unregistered scheme.[9]

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7. Page 18, point 3, ASIC Discussion Paper.

8. *Corporate Governance International* argues in its research paper that better disclosure may improve governance of conflict-of-interest transactions with related parties, but only if the disclosure is accurate and comprehensive so that the investor is able to make an informed decision about how the conflict of interest may impact the fund (see also ASIC's discussion paper, page 6, in relation to an example of ineffective disclosure of conflicts of interest in research reports).

9. Obviously, officers of the RE, irrespective of whether the fund becomes a registered scheme, will still need to discharge their fiduciary and other general director duties in relation to any conflict of interest.

COMMENT AND PRACTICAL IMPACT

The emerging focus on related-party issues by ASIC is fascinating, given that the great proportion of listed and unlisted satellite fund structures in Australia, for many years, have been modeled on the fund engaging:

- REs that are corporate members of the group which has promoted the fund or are in fact owned and (at least in terms of shareholdings) ultimately controlled by the parent entity of the corporate group.[10]

- Other service providers (whether in respect of asset management or advisory services) that are related parties of the RE.

Many would ask why ASIC has chosen to comment on fund structures and conflict-of-interest scenarios now that the related-party service provider model has been used in Australia for so long that it has become ubiquitous. Until now, regulatory scrutiny of conflict-of-interest issues arising from the engagement of related-party service providers (like the enforcement of the related-party rules in the Corporations Act generally) has been lax.

The ASIC hypotheticals may sound as a "warning shot" across the bows of REs whose fund managers, advisors or other service providers are routinely related parties of the RE and housed within the same corporate group. Clearly, ASIC's view is that in these cases the very fact that the relevant players are related parties triggers an inherent conflict of interest that requires careful management by the directors of the RE to ensure compliance with the Corporations Act duty to put the interests of investors first. The question is whether a new regulatory emphasis on these issues can override what looks dangerously like market practice in structuring funds in a way that makes these kinds of conflicts of interest inevitable.

Whether or not the hypotheticals in the discussion paper forewarn of a more aggressive stance by the Commission in challenging related-party transactions that raise conflicts of interest in the funds management arena will become clear after comments are taken on the discussion paper in June 2006.

At this stage, corporate groups whose business is focused on the establishment and promotion of funds should begin paying greater attention to conflict-of-interest issues, both in the context of establishing funds management structures that rely on related parties as service providers, and in the context of monitoring ongoing dealings with those related parties after they are appointed.

A more extensive and detailed approach to disclosures about the related-party nature of these transactions to investors dealt with in the context of conflicts of interest, and explanation of the rationale for continuing to engage, or conduct business with, related-party service providers—when compared with arm's length service providers—may be helpful when combined with other actions. The opportunity to make such disclosures typically arises when Product Disclosure Statements or prospectuses are issued, or in the governance sections of the fund's annual report.

The development of improved governance practices that have at their core a defined policy distinction between a group's approach to related-party issues on the one hand, and their approach to conflicts of interest on the other, may also need to be considered. It remains common, for example, to see disclosure documents deal with related-party issues but ignore conflict-of-interest issues, notwithstanding the differences between the two.

Independent directors of REs and "external members" of compliance committees should also revisit their compliance systems and assess their adequacy in managing conflict-of-

10. The primary example in the Australian market is, of course, Macquarie Bank, whose A$823 million FY2005 profit result consisted of performance fees of A$104 million from its externally managed listed trust satellites (*Corporate Governance International*, "Governance Deficiencies of the ASX Listed Trust Sector", Research Paper, page 20). There are, however, many other Australian investment houses and banks that have adopted similar models.

interest issues that arise when related parties are appointed as service providers to the fund, and monitoring the performance and conduct of those service providers following their appointment. Based on ASIC's discussion paper, it appears that an effective conflict management system should set out a prescribed approach to assessing whether conflicts of interest are so substantive or significant that the transaction giving rise to the conflict should be avoided altogether.

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