FINANCIAL SERVICES AND FUNDS MANAGEMENT - The Legal Issues

The Legal Issues from a Trustee's View Point

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BACKGROUND

The purpose of this paper is to address some of the more difficult legal issues which arise from a trustee's viewpoint, particularly in relation to their role in administering large superannuation funds. These principles also apply in relation to non-superannuation funds. There are a number of difficult issues which continually arise between the trustees and various fund managers, particularly in the wholesale market.

Essentially a funds management contract can be separated into two major parts. The first part being the terms and conditions of the contract and the second part being the investment mandate. Over the years the terms of the contract with various clients has become relatively settled. However, considerable emphasis is now being placed to specify the terms and conditions which are to apply in respect of specialist investment mandates with emphasis on the permitted investments, constraints and prohibitions.

In addition, the trustees or board members of statutory authority funds must comply with their duties and obligations which are set out in their enabling statute. While many statutory authorities have been declared to be "exempt public sector superannuation schemes" under Regulation 1.04 made under section 10 of the Superannuation Industry (Supervision) Act (SIS Act) in respect of the 1994-95 and 1995-96 years of income, most of these funds have adopted a position that they nevertheless will comply with the spirit and intent of SIS particularly in the terms of their investment management contracts and other general SIS requirements.

Superannuation is becoming a significant area of investment. The amount of moneys being directed into superannuation in Australia over the next decade will be substantial.

A recent survey undertaken by Business Analyst BIS Shrapnel for MLC Limited which appeared in the *Australian Financial Review* of 1 May, 1996 indicated an interesting trend in the preferred manner of savings:

Comment	March 1996 %	March 1995 %	Change
Paying off own mortgage	38%	42%	- 4
Superannuation	18%	13%	+ 5
Investment in residential property	18%	24%	- 6
Cash savings	16%	17%	- 1
Share market investment	10%	4%	+ 6

* Source: BIS Shrapnel - *Australian Financial Review*, 1 May, 1996

While investment in property and the share market will largely depend upon economic conditions, the amount of moneys that is flowing directly into superannuation (some of which I suspect may also be reflected in the share market figures), is reflecting an increasing trend.

TRUSTEES STATUTORY DUTIES

General

Trustees of superannuation funds have a number of fundamental duties some of which are set out in the enabling statute of a statutory authority fund and which are also set out under the common law.

Most statutes clearly specify the objectives and duties of the board in relation to the fund and it is not uncommon to find provisions that the directors must:

- Have regard to the interests of persons entitled to benefit from the fund - that is the members.
- Ensure that the decisions and operations of the board are directed towards achieving its objectives.
- Ensure that the board has, or has access to, the skills, facilities and resources required to ensure that the board conducts its operations and carries out its duties in an efficient manner.
- Establish policies in respect to the administration of the fund and the investment of moneys standing to the credit of the fund and to adopt strategies designed to achieve those policies.
- Determine, authorise or approve programs for the administration of the fund or the investment of moneys standing to the credit of the fund.
- Inform members of the fund about the management and investment of the fund including making available to members of the fund at least once in each year a summary of information relating to the management and investment of the fund.

- To manage and invest the assets of the fund so as to **maximise the return earned on the fund** having regard to:

  (i) the need to provide for payments out of the fund; and

  (ii) the need to **exercise reasonable care and prudence** so as to maintain the integrity of the fund.

In Victoria, for example, the investment powers of a statutory fund which is declared to be subject to the Borrowing and Investment Powers Act 1987 (Vic) are set out in the Governor-in-Council Approvals and the Approval of the Treasurer issued under sections 20, 21 and 22 of that Act. These approvals contain detailed provisions in relation to the various head powers and constraints, (including the trading in derivative securities) with which the various authorities and external fund managers, must comply.

Trustees Equitable Duties

In addition to the statutory duties, there are certain duties which are supplemented by the duties imposed by the general law. These duties may briefly be summarised as:

- a duty to act honestly and in the best interests of the authority;
- a duty to avoid conflicts of interest;
- a duty not to make a profit from the position as a director;
- a duty to keep information of the authority confidential;
- a duty to exercise the appropriate level of care and skill of a director.

Under the general law the standard of care which trustees must adopt in managing the trust properties is that of the prudent person. There have been numerous enunciations of this rule.

In *Re Whiteley* [1] Lord Lindley formulated the standard as follows:

> "The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide."

This general standard of prudence as originally formulated by Lord Lindley applies to all the powers and duties of the trustee and not just investment powers.

A slightly stricter approach was taken by the High Court in *Fouche v Superannuation Fund Board* [2] where it was stated that:

> "... the standard to be applied is the standard of the reasonable prudent man of business, and it is nothing to the point that [the trustees] were not men of business at all."

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1 [1886] 33 Ch D 347 at page 355.

2 [1952] 88 CLR 609 at page 641 per Dixon, McTiernan and Fullagher JJ.

However this standard of the "reasonable prudent business man", as opposed to the "ordinary prudent person" is not new. For example Lord Blackburn in *Speight v Gaunt*[3] stated the following:

> "The authorities show that as a general rule a trustee sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own."

It is insufficient for a trustee to allege that he has done his best, as honesty and sincerity do not amount to prudence.

The fact there has been loss does not necessarily suggest there has been imprudence provided the trustee has acted with due diligence and prudence in the discharge of its investment powers.

Trustees of Statutory Authorities

There is often a question which arises in relation to statutory authorities as to whether the board administering the fund holds the assets comprising the fund as trustee for the contributors. Often this issue is silent in the enabling statute. However, a trust may still be created without the use of the word trust.[4]

The High Court in *Fouche's* case,[5] considered the nature of the relationship between the members of the board and the board itself. Although the court was not required to determine the nature of the relationship between the contributors and the board or in particular if the board was a trustee, the court made the following general observations:[6]

> "We do not think, indeed, that the contributors *are* beneficiaries in a proper sense; they have, of course an interest in the trust fund which would probably give them standing in a court of equity, but they have not such a beneficial interest in the fund as has an ordinary *cestui que trust.* The trust is not a trust for persons but for statutory purposes ... we can see no escape from the view that the individual members of the board owed a duty to the corporation which they constituted and whose property and affairs they controlled and managed."

In the *State Superannuation Board v Trade Practices Commission*,[7] Northrop J made the following observations as to the nature of the relationship between the then State Superannuation Board of Victoria and contributors to the funds administered by the board:[8]

> "First, I do not think that the normal relationship of trustee and beneficiary exists between the appellant and contributors. The contributors have no beneficial interest in the Fund. They no doubt have enforceable rights in relation to it but this is different. The trust as established by the Act is one for statutory purposes ... As such, the proprietary rights in the Fund are invested in the appellant ... and its obligation is to administer them in accordance with the Act."

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3 [1883] 9 App C 1 at page 19.

4 *In Re Kayford Ltd* [1975] 1 WLR 279, per Megarry J, at page 282.

5 At page 628.

6 At page 640.

7 [1982] ATPR 4-282.

8 At page 43,542:

Accordingly, it would seem that the moneys held by a statutory authority board are a trust for statutory purposes, not a trust for persons and the board must comply with the statutory requirements in administering the fund.

Notwithstanding the contributors of each fund in each of the above cases were not regarded as beneficiaries in the proper sense but rather the trust is one for statutory purposes, in *Fouche's* case it was held that with regard to the nature of the duty held by the board in relation to investments that it did not differ materially from the duty which rests on trustees in relation to investments.

SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993

There are a number of threshold issues which must apply to trustees, investment managers and custodians in relation to regulated superannuation funds.

Notwithstanding the exemption for exempt public sector superannuation schemes, a number of statutory authority funds nevertheless comply with the spirit and intent of SIS.

Section 52 specifies that the following trustee covenants are deemed to be included in the governing rules of a superannuation entity:

(a) to act honestly in all matters concerning the entity;

(b) to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an **ordinary prudent person** would exercise in dealing with property of another or for whom the person felt morally bound to provide;

(c) to ensure that the trustees duties and powers are performed and exercised in the best interests of the beneficiaries;

(d) to keep the money and other assets of the entity separate from any money and other assets of the trustee or other person;

(e) not to enter into any contract or do anything else that would prevent the trustee from or hinder the trustee in properly performing or exercising the trustees functions and powers;

(f) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including but not limited to the following:

   (i) the risk involved in making, holding and realising, and the likely return from the entity's investments having regard to its objectives and its expected cash flow requirements;

   (ii) the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;

   (iii) the liquidity of the entity's investments having regard to its expected cash flow requirements;

   (iv) the ability of the entity to discharge its existing and prospective liabilities;

   (v) if there are any reserves to the entity - to formulate and to give effect to a strategy for their prudential management consistent with the entity's investment strategy and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due;

   (vi) to allow a beneficiary access to any prescribed information or any prescribed documents.

It is interesting to compare the different concepts used under the common law of "the reasonable prudent man of business" and the "ordinary prudent person" under section 52(b).

The phrase in section 52(b) in early drafts included the words "ordinary prudent person experienced in business". This was amended as it would mean a person who was not experienced in business could not be a trustee - particularly where trustee boards under SIS require equal member and employer representations.

There appears two duties at common law:

- the duty to act as an ordinary prudent person would in dealing with the property of another; and

- the duty to act as a prudent person experienced in business would in dealing with their own property.

I understand SIS decided to codify the first of these duties only, for the reason as outlined above.

The purpose of the section 52 covenant is to ensure that trustees are in fact in control of their funds and can be held accountable.

Section 58 of the SIS Act provides that subject to certain exemptions the governing rules of a superannuation entity, other than an excluded fund, must not permit the trustee to be subject, in the exercise of any of the trustees powers under those rules, to direction by any other person.

This section has significant implications for statutory authority funds particularly where, as is the case in Victoria, the investment powers of a number of statutory authority funds are set up under the Borrowing and Investment Powers Act 1987 which is subject to the direction and control of the Treasurer.

Under that section the Treasurer issues certain approvals which specify the investment powers of each authority and has certain constraints issued under the approvals in relation to those powers.

Section 122 of the SIS Act provides that an investment manager of a superannuation entity must not appoint or engage a custodian of the entity without the written consent of the trustee of the entity.

Section 123 provides that a person must not intentionally be the custodian of a superannuation entity (other than an excluded fund) unless the person:

(i) is a body corporate and the value of the net tangible assets of the body corporate is not less than $5 million; or

(ii) that entity is entitled to the benefit of an approved guarantee for the benefit of the trustee for that amount; or

(iii) there is a combination of the two.

Section 124(1) of SIS provides that the investment managers must be appointed by the trustees in writing. Section 125 requires that a person must not intentionally be, or act as, an investment manager of a superannuation entity (other than an excluded fund) if the person is not a body corporate.

Body Corporate Requirement

The requirement for the investment manager to be a body corporate may present a problem particularly for fund managers and trustees subject to SIS where the body corporate is a limited partnership. The term body corporate is not defined in the SIS Act and it is necessary to adopt its usual meaning under Australian law.

In most instances, it will be necessary for trustees to ensure that they are dealing with a body corporate and it will be necessary, particularly in the case of overseas fund managers, to carefully determine that status.

A recent development in the United States has seen the emergence of limited liability companies which replace the limited partnership concept. These companies have special characteristics and are usually established by statute.

The State of New York has recently introduced such legislation. Whilst establishing a company which would be accepted for the purposes of the SIS Act, there are certain requirements associated with these entities which provide:

- that there is a limited life and usually a date upon which the entity will be dissolved;

- under the operating agreement (which is not a public document), of a limited liability company, there are usually provisions whereby the entity can be dissolved prematurely; and

- under the enabling statute of the State of New York, for example, there is a requirement for the entity to lodge a "proofs of publication". The effect of this requirement is that if the proofs of publication as required under the statute are not lodged, then a trustee cannot bring an action against that entity in the State of New York.

Disqualified Persons

Section 126 provides that a person must not intentionally be, or act as, an investment manager of a superannuation entity (other than an excluded fund) if the person is, and knows that the person is, a disqualified person.

Section 126 of the Act has been incorporated to provide that this prohibition also applies to a custodian of a superannuation entity.

Section 120(1) prescribes that an individual is a disqualified person if:

- at any time (even before the commencement of this section)

  (i) the individual was convicted of an offence against or arising out of a law of the Commonwealth; a State or Territory or a foreign country, being an offence in respect of dishonest conduct; or

  (ii) a civil penalty order was made in relation to the person; or

- the person is an insolvent under administration.

Under section 120(2), a body corporate is a disqualified person if:

- the body corporate knows, or has reasonable grounds to suspect, that a person who is, or is acting as, a responsible officer of the body corporate is a disqualified person and remains so for 28 days;

- a receiver, or a receiver and manager, has been appointed in respect of property beneficially owned by the body; or
- an official manager, deputy official manager or administrator has been appointed in respect of the body; or
- a provisional liquidator has been appointed in respect of the body corporate; or
- the body corporate has begun to be wound up.

Declarations by the Commissioner

Section 126B(1) enables an individual to apply to the Insurance and Superannuation Commissioner for a declaration under section 126D waiving his or her status as a disqualified person for the purposes of this part of the Act, only if the person is a disqualified person under section 120(1)(a)(i), and the offence leading to him or her being a disqualified person was not an offence involving **serious dishonest conduct** as described in section 126B(2).

An offence is regarded as being "serious dishonest conduct" if the penalty imposed for the offence was:

- a term of imprisonment of at least two years or longer; or
- there was a fine of at least 120 penalty units.

It should be noted that under section 126D(1) the ISC must notify the **applicant** who has applied for a waiver of the provisions of this section. At present there does not appear to be a requirement that the ISC must advise the trustees or the investment manager or the custodian as the case may be.

There is a requirement under section 126D(4) that if the Commissioner becomes aware that the responsible officer of a body corporate that is a trustee, investment manager or custodian and has failed to resign in accordance with the Commissioner's requirements, if the matter reaches that stage, the Commissioner can then tell the body corporate that the applicant is a disqualified person.

I have some concerns that this can only happen at the end of the process.

INVESTMENT MANAGEMENT CONTRACTS

There are a number of matters which the investment management contract should address from a trustee's viewpoint. Not unexpectedly, the provisions in the standard Investment Manager's Association fund management contract, which have been prepared primarily by fund managers from a fund manager's perspective, will differ markedly to the provisions which trustees should require on these issues.

Some of the major matters which should be addressed are:

Transfer and Termination

Often the trustees will need a right to effect a transfer or a termination immediately, without notice and without reasons.

This can happen where there is a change in the investment policy of the trustees or where the trustees have discovered that there has been a major breach of the terms and conditions of the investment mandate.

The contracts should make a distinction between the transfer of a whole or part of the portfolio and the termination of the appointment. The trustees may need to re-balance the fund and move a portion of the moneys allocated to an investment manager without necessarily terminating the appointment.

Performance Guarantees and Indemnities

It is not unusual for trustees of large portfolios to require the fund manager to procure a parent or related company to provide either a performance guarantee and indemnity in support of the obligations of the fund manager under the fund management agreement or provide a letter of comfort, dependent upon the commercial standing of the fund manager.

The performance guarantee and indemnity is taken to provide additional support to the trustees in the event of a breach of contract, particularly where the breach may not necessarily be covered by the fund manager's insurance.

In some instances the fund manager will be ultimately owned by a trading bank. In these circumstances, as a result of the central bank's capital adequacy and prudential guidelines, these entities will not be permitted to provide a performance guarantee and indemnity.

It is then a matter of commercial negotiation between the trustees and the fund manager to determine whether they will accept a performance guarantee and indemnity from another entity in the group which may not necessarily be subject to the prudential supervision requirements of the central bank or alternatively to provide a letter of comfort from another entity in the group to provide if not a legal, then at least a moral obligation that the parent entity is aware of the contractual arrangements and will ensure that the fund manager is in a position at all times to meets its obligations.

Letters of Comfort

It is generally accepted that subject to the wording of the letter of comfort, these documents will not usually be regarded by an Australian court as constituting an intention to create a legal and binding obligation between the parties.

In determining whether a letter of comfort gives rise to a contractual obligation, the ordinary rules of construction and interpretation relating to contracts will apply. The overriding test is that of the intentions of the parties as deduced from the document as a whole seen against the background of the practices of the particular trade or industry and in the events surrounding its inception.[9]

Nevertheless, it may be appropriate to request a letter of comfort to ensure that there is at least a moral and commercial obligation, if not a legal obligation, which is placed upon the parent entity of the fund manager, particularly in view of the nature of these contracts and the amount of money which is being placed with these entities for investment.

Insurance

It is often the parent company of the fund manager which arranges its insurance cover and not all fund managers have control over the terms and conditions of their insurance. In some instances, the terms of the insurance are not permitted to be disclosed. In these circumstances, while the trustees will require certain categories of insurance to be in place, such as professional indemnity insurance, electronic and computer crime fraud insurance and fidelity insurance, the terms of the

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9 *Banque Brussells Lambert SA v Australian National Industries Limited* (1989) 21 NSWLR 502 at page 521.

insurance may be such that the insurer may ultimately reject a claim made by the fund manager at the request of the trustees arising out of a breach of contract.

The performance guarantee and indemnity is taken as a precaution by the trustees to help protect them against loss to the fund.

Liabilities and Indemnities

Section 116 of the SIS Act provides that any provision of an agreement between the trustee of the entity and an investment manager that purports to exempt the investment manager from liability for negligence, or to limit that liability, is void.

One of the fundamental terms of the contract will relate to the indemnities and the liability of the fund manager. The indemnities usually provide that the fund manager will be liable for the acts or omissions of the fund manager, its officers, employees and agents for any reason in relation to the portfolio (including loss arising from unauthorised acts, negligence, wilful default, fraud or dishonesty).

A vexed area at present is what is meant by the term "agents" and what is the liability of the fund manager for the acts or omissions, particularly, of brokers.

The standard Australian Investment Managers Association contract clearly provides that it is the trustee who will be liable for the acts or omissions of brokers.

This is not a position which trustees of large statutory authorities superannuation funds would or should accept.

The powers of a statutory authority will usually permit the appointment of external fund managers to invest in certain categories of investment. Implicit in this appointment is a requirement and understanding that the fund managers themselves will have to engage specialists to assist them in meeting their duties and obligations under the contracts. One of these matters relates to the engagements of share brokers and futures brokers to assist in the buying and the selling of the shares and derivative securities.

A number of major trustees are now taking a firm position that it must be the fund manager who is to be responsible for the acts or omissions of these entities and that this is fundamental and one of the non-negotiable terms of the agreement, particularly in respect of large portfolios. It should be realised that it is the fund manager which engages the broker and instructs the broker. Insofar as the trustees are concerned, they should not have involvement in this process.

The one area which does cause some concern to both parties relates to loss arising from counterparties (ie third parties on the other side of the transaction to the trustee and the fund manager or its brokers). In these circumstances, if the loss arises due to counterparty risk, the fund manager may require an exclusion from the indemnities for this risk. It would not be unreasonable for the trustees to accept counterparty risk provided that the fund manager properly complied with its policies and procedures in relation to the appointment of counterparties and that the individual credit limits and other matters in the fund manager's policies and procedures had also been complied with. Where a counterparty loss arises outside the fund manager's policies and procedures, then the loss would remain with the fund manager.

Cross Indemnity

A number of investment managers often request trustees for an indemnity for costs and other matters under the contract.

This is not a provision which I usually permit. In essence, a fund management contract is one where a fund manager is engaged to provide services to the trustees. It is not a contract with mutual obligations. As most of the obligations move from the fund manager to the trustee in complying with the provisions of the contract including the terms and conditions of the investment mandate, in my view it is the trustees and the funds which they administer which should be requiring the protection given the nature of these contracts, and not the fund manager.

If the fund managers are concerned on any issues, including reimbursement of brokerage and other costs and outgoings, these should be separately addressed in the costs and expenses section of the contract but should in no way require the fund manager to provide an indemnity of the nature usually requested.

Soft Dollar Arrangements

The contract should have a constraint or prohibition against the use of soft dollar commissions or alternatively limit the use of soft dollar commissions to a specified percentage (usually either 10% to 20% maximum).

Soft dollar arrangements are where a fund manager engages a broker and in consideration for the amount of brokerage which is paid as a result of the trades, the fund manager receives some benefit in the form of computer programs, asset allocation information and other matters which the fund manager can use in its business.

From the trustees viewpoint, the problem arises where there is a lack of disclosure of these benefits which the fund manager receives which effectively is as a result of the moneys placed in the market by the trustees.

Trustees of some statutory authorities usually require that soft dollar brokerage be prohibited.

Conflicts of Interest

Conflicts of interest are a difficult issue particularly where the fund manager which is appointed has a number of operating divisions in addition to portfolio management and investment. In many instances, one part of a fund manager's organisation will be acting for the trustees while another part of the organisation may be acting as advisers to companies in which the portfolio is invested. Not unexpectedly, the fund manager will require protection under the contract in the event that this situation arises.

It is not unusual for provisions to be included in the contract to provide that the trustees recognise that:

- the fund manager can act as a financial adviser or an investment manager for an entity in which part of the portfolio is invested - if so there should be disclosure to the trustees to enable them to consider and assess this position;

- the fund manager in acting as a financial adviser may acquire confidential information which that person is not entitled to act upon. In these circumstances the trustees should be advised by the fund manager that there is a conflict to enable them to consider the action that they may wish to take.

Pooling of Investments

Because of the nature in which most fund managers purchase securities in bulk, they will usually require a provision that will permit them to pool the funds of the trustees with those moneys belonging to other clients of the fund manager where that is necessary for the efficient management and administration of the portfolio. The fund manager then allocates the investments acquired amongst its various clients.

Trustees should be careful with these provisions particularly if the fund manager, as is often the case, is a manager of a unit trust or pooled superannuation trust where it may decide to place better investments in its own entity to ensure that the return on investment is improved or maintained and the less attractive investments may be allocated to other portfolios. This of course will never be admitted.

In order to prevent a dispute in this area trustees should, where these provisions are requested, require the portfolio managers responsible for the investment decisions to obtain an authority in writing from a senior person in the fund managers officers to approve the particular investment for the portfolio prior to the trustees moneys being pooled with other client moneys managed by the fund manager.

ISC Risk Management Statements

The Insurance and Superannuation Commission has issued new guidelines for the operation and control of derivative securities transactions by superannuation funds dated April, 1996.

The guidelines are issued under the ISC Superannuation Circular Number II D7 dated November 1995 to which the final guidelines will be annexed as an appendix.

The source of the risk management statement for derivative securities are the covenants contained in paragraphs (c) and (f) of section 52(2) of the SIS Act.

The matters set out in the draft Risk Management Statements have been prepared after wide consultation with representatives from the industry including both trustees, fund managers, asset consultants and investment advisers and provide for both the trustees and the fund managers to each prepare a risk management statement. The trustees are required to prepare a risk management statement in the form of Part A and the fund manager is required to prepare a risk management statement in the form of Part B.

The objectives of the ISC are to ensure that trustees and fund managers which use derivative securities have appropriate policies and procedures in place for their use and control and that there are adequate checks on compliance within those policies.

The ISC circular makes reference to a number of obligations placed on trustees some of which are:

- to ensure that the trustees regularly review their investment strategy policies and risk management policies in relation to derivative securities;

- where trustees are subject to SIS, they must make specific comment where they use derivative securities in the ISC annual return for the 1996/1997 and subsequent years and that they have approved the risk management statement, that they understand its contents and that they have monitored the operation of the risk management statement and have received regular reports;

- where a trustee is using an external professional investment managers, the trustees should

  - identify its objectives in using the derivatives;

  - identify its risk tolerances;

  - ensure that it is aware of and is satisfied with all significant policies and procedures adopted by the investment manager relating to the management of risk (this would include a separation of the duties from those trading in derivatives with those persons reporting on and administering those trades);

  - ensure the trustee is regularly informed by the investment manager of the derivative securities exposures, in particular the aggregate exposure (both derivatives in isolation and combined with the physical exposure);

- ensure that the investment manager regularly undertakes simulations and sensitivity analysis to provide an indication of the impact of market movements on the whole of the portfolio.

The statement should clearly set out the types of derivative securities which are permitted, the limitations on usage and the controls to be achieved. It should also specify the rules which are to apply to respect of particular investment mandates, and that there are appropriate rules to restrict the use where the potential exposure cannot be reliably measured, where it is difficult to close out a derivative contract considering the illiquidity of the market or where the derivative security is not readily market (for example over the counter options or where the counterparty is not suitably credit worthy). Most statutory authority trustees only permit trading in futures contracts and options on futures contract which are traded on a recognised futures exchange. As such, over the counter options are usually excluded.

The trustees should also develop a checklist as to those matters which they require to be addressed in the Fund Manager's Risk Management Statement - Part B.

SECURITIES LENDING TRANSACTIONS

There has been an increase in the amount of activity undertaken in Australia over the past few years in relation to securities lending transactions.

The term "securities lending" is a misnomer as in fact most of these transactions are a purchase and sale of equities with an agreed repurchase and at the conclusion of a contract.

One of the main reasons for an institutional investor entering into a securities lending transaction is to increase the return on investment of the portfolio from the fees paid for the loan of the securities and income earned by the lender investing the collateral.

The borrower in turn receives the shares either to settle outstanding transactions due to a lack of available scrip and/or obtain the benefits such as imputation franking credits and dividend rebates attaching to the shares or alternatively the borrower can sell the shares to raise cash to assist in further diversifying the portfolio. The borrower must ensure that equivalent shares are purchased to "repay" the lender on the due date.

There are a number of major components to a securities lending transaction particularly from a lender's viewpoint:

- the lender usually transfers the full legal and beneficial ownership in the shares lent to the borrower against an undertaking to re-deliver shares of an equivalent type to those lent on the due date;

- the borrower transfers free and clear title in the collateral, being cash or other agreed security to the value of the securities lent, together with an agreed amount of margin cover to the lender;

- the lender receives a fee for making the securities available and, if applicable, a compensation amount for the dividend and other income forgone. Interest and other income, if any, on the investment of the collateral is usually dealt with as part of the income compensation package;

- during the term of each "loan", there will be regular adjustments to the amount of the collateral to maintain the loan value to collateral value established at the commencement of the arrangement;

- at the end of each "loan", the securities and the collateral are returned and the parties are restored to their original position;

- in Australia each individual loan transaction (that is, a transfer and re-transfer) cannot exceed 12 months otherwise capital gains tax will apply.

Income Tax Assessment Act - Section 26BC

The provisions of section 26BC were incorporated to overcome the capital gains tax provisions of the Income Tax Assessment Act 1936 (Cth). The provisions are complex and require a number of matters to be satisfied in order to fall within the capital gains tax exemption.

A number of matters should be noted in order to strictly comply with the section 26BC exemption:

1. There is no definition of "a security lending arrangement".

2. It is necessary for this arrangement to be in writing and it is usual to see separate securities lending agreements between the lender and an agent and a securities borrowing agreement between the borrower and that agent.

3. In considering each of these agreements, it is necessary to ensure that the transfer of title particulars are consistent and identical.

   Whilst absolute transfer and title seems to be prevalent in current securities lending transactions, many early transactions, particularly in the United Kingdom, were based on a pure lending arrangement where each party retained title and beneficial ownership. In these circumstances, it was necessary to give consideration as to whether the securities borrowing agreement should be registered as a charge against the shares being subject to the securities lending arrangement.

4. For shares to be subject to a securities lending arrangement, under section 26BC(1), the shares must be issued by a public company. In most instances not only are they shares issued by a public company, but they are also listed on the Australian Stock Exchange Limited or a recognised major overseas stock exchange to permit ready marketability.

5. The period for each transaction must be less than 12 months after the original disposal time (section 26BC(3)(a)).

6. Both the borrower and the lender must be independent of each other and deal with each other at arm's length (section 26BC(3)(b)).

7. There must be detailed provisions in the agreements relating to the rights to the dividends and options and the payments which are to be made between the parties in relation to distributions which must ensure that the borrower pays the lender an amount equal to the value of the lender of the distributions. Distribution is defined in section 26BC(1) to cover interest, dividends, the share issued by a company as a bonus share and other amounts credited by a trustee of a unit trust to a unitholder as a unitholder.

8. The lender must not dispose of the right to receive any part of the total consideration payable or to given by the borrower under the agreement.

Provided that section 26BC is strictly complied with, the effect of these provisions is the lender is relieved from the transaction being an acquisition or disposal of assets, so that, provided that the term of **each loan** is less than 12 months, the capital gains tax provisions of the Income Tax Assessment Act will not apply.

It should also be noted that there are certain stamp duty exemptions for securities lending transactions in most states including Victoria (where securities lending transactions are exempt from the payment of marketable securities duties). These provisions have been included in the latest draft of the Stamp Act re-write currently being considered.

There are a number of areas of risk in so far as the lender is concerned being:

- ***Counterparty Risks***

  This risk relates to the assessment by the lender of the ability of the borrower to perform its obligations under the agreement. As the transaction is a series of individual transfers and retransfers, the obligation on the borrower to return the equivalent securities lent on the due date is a contractual right of the lender under the agreement.

- ***Collateral***

  The areas of risk in relation to collateral can arise in respect of valuation, exchange risks, income cover and inherent limitations built into the collateral itself and the lender must be satisfied that it can readily liquidate the collateral if and when required.

- ***Default***

  Default can occur when the borrower has not returned equivalent securities to the lender on the due date. If this occurs it is essential that the title and transfer provisions in both the borrowing agreement and the lending agreement are consistent to enable the lender to immediately attach to the collateral and use it as its own moneys.

- ***Settlement and delivery risks***

  This risk arises if the lender is prepared to part with the securities before it receives the collateral and whether it is prepared to be subject to daylight exposure.

  Daylight exposure arises where the settlement of the securities transferred and the settlement of the collateral transferred takes place at a different time. This is more likely to be an issue in the international market.

- ***Voting rights***

  It is a matter for the parties to determine who will exercise voting rights attaching to the various securities.

- ***Systems and controls procedures***

  This risk arises where the lender does not have proper and effective internal systems and control procedures in place to monitor and report on all aspects of the transaction. Internal systems must deal with:

  - recording in detail the inventory of securities lent for each transfer;

  - recording the amount and nature of collateral received for each transfer;

  - regularly monitoring the value of the securities and the collateral;

  - promptly reacting to necessary adjustments to the value of the collateral;

  - tracking the movement of dividend and other income entitlements relating to the securities to ensure that both dividend income and take over offers and rights entitlements are properly controlled.

- ***Power to enter into the proposed transaction***

  It is necessary to ensure, particularly in relation to a statutory authority, that there is specific provision in its investment powers to permit securities lending transactions.

In the case of Victorian statutory authorities subject to the Borrowing and Investments Power Act 1987, there is a specific head of power which has been included and which itself is subject to further constraints which are set out in the approval of the Treasurer.

CONCLUSION

The purpose of this paper has been to provide an overview of some of the major issues affecting trustees in relation to their duties and obligations to the members of their funds.

In view of the nature of the trustees' duties, and the types of matters outlined above, they should seek expert assistance, if nothing else, to ensure they have done all that a reasonably prudent person would have done to protect members' interests and rights in respect of their investments and entitlements.