

Corporate Advisor

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Banning commissions—consequences for product issuers

Commissions

As the debate over banning commissions rages on, product issuers should be keenly aware this debate is not one that affects financial planners alone.

The consequences of a ban on commissions for product issuers should not be underestimated. Such a ban is likely to have a profound effect on the way financial product advice is given in this country, and who it is given by.

ASIC and IFSA call for ban

In its submission to the Parliamentary Joint Committee (PJC) on Corporations and Financial Services' *Inquiry into Financial Products and Services in Australia*, ASIC has recommended that just about all forms of commission-based remuneration for the provision of financial product advice be banned, including upfront and trail commissions, soft dollar incentives, volume bonuses, rewards for achieving sales targets and fees based on a percentage of funds under advice.

ASIC's reasons for recommending a ban on commissions is that this form of remuneration can encourage advisors to sell products rather than give strategic advice and recommend products that may be inappropriate but are linked to higher commissions. ASIC says remuneration based on funds under advice also encourages advisors to sell and not advise and to encourage their clients to borrow to invest. ASIC also believes that disclosure is an ineffective tool to overcome these conflicts of interest.

Coupled with the release by the Investment and Financial Services Association (IFSA) of its draft "Super Charter", which also recommends a movement away from commission-based remuneration, ASIC's submission should put product issuers on notice that the regulatory landscape may change significantly in the next 12 to 24 months.

Potential consequences for product issuers

Product issuers need to consider the potential consequences a ban on commissions may have not only on the way they distribute their products, but also on the financial services industry as a whole. The consequences might include the following:

1. Entry of new competitors

If the commission tap is going to be turned off, then financial planning firms will need to find a new way of sourcing income. If they take the view it is unlikely their clients are going to pay the same amount as a fee for service as they do in upfront and trail commissions, then one of the ways financial planning firms might seek to preserve their remuneration which is a percentage of funds under advice, is by selling their own products and taking a management fee as a responsible entity. As Australian financial services licensees, it would be a relatively small step for them to take to obtain the appropriate authorisations to operate their own schemes and to operate funds of funds.

2. Closure of distribution channels

Product issuers may struggle to maintain their distribution networks if the consolidation in the financial planning industry occurs, as ASIC itself predicts will probably take place as a result of a ban on commissions. ASIC says that in its view, commissions could continue to be used to remunerate the representatives of the product issuers provided they do not hold themselves out to be advisors. So it may be the case that the future of distribution for product issuers lies within their own distribution arms.

Whatever the other outcomes of the PJC inquiry, we can, in the least, expect a fundamental shift in how financial products in this country are sold. Product issuers need to keep in mind, a ban on commissions is not an issue that affects financial planners alone.



If you would like more information, then please contact **Chris Mee** by email or on 07 3239 2957.

A parent company's responsibility for its subsidiaries

The corporate veil

Australian courts have long held that a company is a separate legal entity, distinct from its shareholders and members, with all of the powers of a natural person. This doctrine is enshrined in the *Corporations Act 2001* (Act) and has formed the basis of company law in Australia.

As a separate legal entity, any duties or obligations of a company are incurred by that company alone and not by its members. As a result, a creditor or third party may not look to the members of a company to satisfy any outstanding debts or liabilities of the company. The inability of outsiders to pursue members of a company for the actions of the company is referred to as the “corporate veil”.

The corporate veil and groups

The courts have applied the separate legal entity doctrine to a corporate group so that a corporate group is generally protected by the corporate veil in the same manner as a single company. That is, although a parent company is the sole member of a subsidiary company, an outsider dealing with that subsidiary company may not look to the parent company to satisfy its debts or obligations. The two companies are separate legal entities and as a result this structure is often used to quarantine liability within one company in a corporate group. While this is generally an effective risk management strategy, the courts will lift the corporate veil and look through to the parent company in some circumstances.

Recent case

A recent case highlights the potential risk of liability a parent company may face for the actions of its subsidiaries.

In *Ackers v Austcorp International Ltd*, the parent entity in the Austcorp Group was approached to participate in the development of a resort and established a subsidiary company to undertake the marketing, promotion and sales of apartments at the resort. The parent was heavily involved, through common directors, in the development of the marketing and promotional material and included its company logo in the material and at the development site.

The marketing and promotional material guaranteed investors a seven percent per annum return for ten years. The return was paid only in the first year and a number of investors sued the parent entity for misleading and deceptive statements made in the promotional material.

The parent argued the appropriate defendant to such an action was its subsidiary, as the company responsible for the marketing and sales, and that an ordinary person would not necessarily assume the parent was involved with the development merely because its logo was on the promotional material.

The court rejected this argument, saying that no one who saw the signs at the development site or logos on the promotion material would stop to ask whether this material identified a special purpose subsidiary. The court found the use of the parent name and symbols created an association with the group and, importantly, with the common company involved in the projects, being the parent.

The parent also argued that although there were common directors, those responsible for the marketing and promotion were wearing their subsidiary “hats” when such material was being developed. The court also rejected this argument.

Liability for a subsidiary under the Act

A parent company may also be liable for the insolvent trading of its subsidiaries under section 588V of the Act. Under that section a parent company will be liable for its subsidiary where the company or its directors are aware, or should have been aware, that the subsidiary was insolvent. A breach of section 588V may result in an action against the company by the subsidiary's liquidator for the amount of loss or damage suffered by a person to whom the debt was due.

Conclusions

Although a group structure is an effective means of organising the affairs of a group of companies and quarantining liability, it should not be assumed that a parent company will be completely insulated from liability for its subsidiary's actions in all circumstances. Where a company is involved in a matter and seeks to use subsidiaries to undertake particular activities, the parent company should carefully consider the effectiveness of the structure and the potential liability if the corporate veil is lifted.



If you would like more information, then please contact **Sarah McDonald** by email or on 07 3239 2957.

Website disclosure

New policy

ASIC has recently released a new policy statement providing an alternative method of continuous disclosure for unlisted entities to the current regime under the *Corporations Act 2001* (Act).

Regulatory guide 198: Unlisted disclosing entities: Continuous disclosure obligations (RG 198) recognises the failings associated with the current regime for unlisted companies who are required to comply with the continuous disclosure provisions of the Act and aims to facilitate continuous disclosure via a company's website.

Why has ASIC issued RG 198?

ASIC has, in RG 198, tried to address the following failings of the current continuous disclosure regime for unlisted companies:

1. It is often difficult to decide what information has "a material effect on the price or value" of shares for the purposes of the Act. RG 198 uses the term "material information" rather than the exact language of the Act. This is seemingly broader than the Act's requirements, with ASIC expecting to see

disclosure about all material matters, including those which may not necessarily have a material effect on the price or value of shares. However, in practice, there is likely to be little difference between the statutory test and that talked about in RG 198, given the Act says any information which would be likely to influence investors in deciding whether or not to invest is taken to be information which must be disclosed to ASIC.

2. While the Act currently requires continuous disclosure information to be provided only to ASIC, RG 198 acknowledges it is more effective to actually provide the information to investors (through website-based disclosure), as investors require it to make investment decisions. Website disclosure is obviously the better way to keep investors informed.

It is arguable, for these reasons, that RG 198 sets out a more onerous disclosure regime than the Act currently requires. However, in reality, using websites to keep investors updated about material matters reflects the existing approach of many companies and fund managers.

Website use—preconditions

Companies and managers of funds which are “disclosing entities” should satisfy themselves their shareholders/investors are likely to look for important information on their website. New and existing investors must be advised the manager’s website will be used for disclosure purposes. Existing investors should be notified through normal communication channels.

After 30 September 2009, ASIC expect all PDSs and prospectuses to contain disclosure about which method an entity will use to satisfy the continuous disclosure obligations (i.e., by lodging notices with ASIC or following ASIC’s good practice guidance).

Good practice guidance

ASIC will be monitoring website disclosure by disclosing entities, to ensure good practice is being followed. ASIC considers good website disclosure has the following features:

1. Material information appears in one single place.
2. A prominent link to the information appears on the homepage.
3. Material information is included on a website regardless of whether it is also in another document.
4. Material information is not “buried” amongst other information.
5. Material information that is difficult to identify is highlighted to investors.
6. Information is published ‘as soon as practicable’.
7. The date of publication of each item is clear.

8. Material information is retained on the site for as long as it is important to an investor's decision.

In addition to website disclosure, ASIC suggests companies and fund managers may also provide information directly to investors, and ASIC strongly encourages them to provide the option of receiving an email alert when material information is updated.

Intended alternative

ASIC has stated it will *'not insist'* that disclosing entities lodge notices, if the website disclosure is sufficient. ASIC considers RG 198 therefore sets out an alternative to the current statutory continuous disclosure regime for those who comply with ASIC's good practice guidance.

However, it should be kept in mind that whilst ASIC's new approach is sensible and practical, the continuous disclosure obligations in the Act remain as they were; and at this stage, the new system which ASIC is seeking to implement does not have the force of law. RG 198 therefore (unfortunately) does not relieve a company or fund manager from the technical requirement to lodge "price sensitive" or influential information with ASIC. As long as this remains the statutory position, companies and fund managers should consider continuing to lodge notices of important developments and changes with ASIC, as well as posting the information on their websites.



If you would like more information, then please contact **Nicole Singer** by email or on 07 3239 2906.

The court's ability to remedy member meeting irregularities

Procedural irregularities

A recent decision of the Federal Court has provided some guidance about the circumstances where the court will step in to cure procedural irregularities.

The facts

In *City Pacific Limited v Trilogy Funds Management Limited*, a group of members of City Pacific's First Mortgage Fund sought to have City Pacific removed as the responsible entity of the Fund and replaced with Trilogy Funds Management (Trilogy). The resolution that was proposed (and passed) at the meeting of members read as follows:

"That City Pacific Limited ... be removed as responsible entity of the City Pacific First Mortgage Fund ... in accordance with section 601FM(1) of the Corporations

Act and that Trilogy Funds Management Limited ... be appointed as responsible entity of the City Pacific First Mortgage Fund.”

The issues

City Pacific argued the resolution was invalid because the *Corporations Act* (Act) requires two distinct extraordinary resolutions at a meeting of the members as follows:

1. One resolution removing the serving responsible entity.
2. One resolution appointing its replacement.

Trilogy argued the Act does not require separate votes on the two issues, and even if the Act does require separate votes, then it is simply an irregularity that can and should be remedied by the court pursuant to powers granted to the court under the Act.

The decision

The court concluded the Act does not require separate votes on each of the individual issues and, accordingly, the resolution was validly passed.

Remedying irregularities

Even though the court was able to dispose of the matter by determining the resolution was valid, the court still dealt with the arguments of the parties that in the event the resolution was invalid (for non-compliance with the Act), then the court should exercise its discretion under the Act to remedy that irregularity.

The court confirmed it would have exercised its discretion to cure the irregularity (if it had to) and it made the following comments about its power:

1. The discretion only applies to remedying procedural irregularities and not substantive irregularities.
2. It is clear the adoption of a resolution at a meeting is procedural in nature.
3. However, the wrongful denial of a unitholder’s statutory right to vote at a meeting would be a denial of a substantive right and not capable of being cured by the court.
4. The absence of a quorum has expressly been defined to be a procedural irregularity.

Summary

The court has the power to remedy an irregularity concerning meetings of members of registered schemes, however, the irregularity must be procedural in nature and the complainant must suffer a substantial injustice if the irregularity is not remedied.

If you have any concerns about decisions having been taken that may not have complied with the Act, then we may be able to assist you to apply for relief to the court.



If you would like more information, then please contact **Brit Ibanez** by email or on 07 3239 2960.

Corporate law update

Rumourtrage

ASIC has released Consultation Paper 118: *Responsible handling of rumours* (CP 118) which contains principles and guidelines to assist market participants in dealing with market rumours. The *Corporations Act 2001* (Act) prohibits making false and misleading statements in communicating material inside information. ASIC has stated CP 118 is designed to supplement these provisions and includes requirements for Australian financial services (AFS) licensees to adopt policies to manage when staff representatives can pass on rumours, both internally and externally. ASIC is seeking views on whether its proposed principles provide sufficient guidance for AFS licensees to exercise judgement in respect to identifying rumours and handling them. The paper will apply to stock brokers, investment advisors and investment managers. The consultation period ends 9 November 2009.

Changing the constitution—managed investment schemes

ASIC has recently issued new class order relief (CO 09/552) which provides relief to responsible entities of registered schemes to modify, or repeal and replace, scheme constitutions. Under CO 09/552, a responsible entity may alter the constitution of the scheme where certain criteria are satisfied. These include—

1. where a meeting of members is unable to be held because the quorum requirements in the Act or the scheme's constitution are not satisfied
2. members of the scheme are not entitled to vote because of section 253E of the Act, or
3. all interests in the scheme were issued where a product disclosure statement was not required or disclosure was not given under the Act.

These changes may only be made if before the modification, or repeal and replacement, the responsible entity has provided to each member, the auditor of the scheme and the scheme's compliance plan all material information in relation to the decision and every member has given their written consent to the modification, or appeal and replacement.

Contact

For more information, then please contact Sarah McDonald, a solicitor in our corporate team.



Sarah McDonald can be contacted by email or on 07 3239 2957.

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