

Growing Wealth

November 2009

PJC report in

Inquiry into financial products

The Parliamentary Joint Committee on Corporations and Financial Services (Committee) this week tabled its report to Federal Parliament on its inquiry into financial products and services in Australia.

Recommendations

The Committee has made 11 recommendations for reform, the most significant for the agribusiness investment sector being as follows:

1. Agribusiness responsible entities must demonstrate they have sufficient working capital to meet current obligations. The recommendation is that this requirement be part of the Australian financial services (AFS) licence conditions imposed on responsible entities.

The Committee stated this measure is designed to prevent ponzi-like structures when new product sales are required to prop up existing schemes.

2. The *Corporations Act 2001* (Act) be amended to allow the Australian Securities and Investments Commission (ASIC) to deny an AFS licence application, or suspend or cancel a licence, if there is a reasonable belief the licensee “may not comply” with their licence obligations. Currently, ASIC must be satisfied the licensee “will not comply” before it can take such action.
3. The Act be amended to explicitly include a fiduciary duty for financial advisors operating under an AFS licence, requiring them to place their client’s interests ahead of their own. This is one of two recommendations highlighted by ASIC in its submission to the Committee that would have the most far reaching impact.
4. The second significant ASIC recommendation was a total banning of commissions as remuneration for provision of financial services. As has been recently anticipated in the financial press, the Committee has not fully adopted ASIC’s recommendation. Instead, it has recommended the government consult with industry in developing the most appropriate mechanism to cease payments being made from product manufacturers to financial advisors. The move to fee for service remuneration is still inevitable but the transition may be less drastic than if a total ban was implemented straight away.

5. The Act be amended to require advisors to disclose more prominently in marketing material the restrictions on the advice they can provide and any potential conflicts of interest.

Not included

Significantly, the Committee did not make certain recommendations which were the subject of submissions, including from ASIC:

1. Increasing the financial requirements to be met by AFS licensees, including responsible entities. ASIC was flagging that a capital adequacy requirement could be introduced.
2. Placing an obligation on responsible entities to ensure their products were suitable to retail investors to whom they promoted—in other words, a requirement to give **personal** financial product advice.
3. Prohibiting the sale of certain products to retail clients where the risk and complexity was considered too high.
4. Introducing different standards of advice depending on whether an advisor is fulfilling a sales function or offering independent financial advice (although the Committee did state that a proposed professional standards body for financial services – a separate recommendation – could require that people describing themselves as advisers must adhere to certain standards).

Updates

Ultimately, it is a matter for government which recommendations will be adopted but legal and regulatory reform is inevitable.

In coming McMahon Clarke Legal newsletters we will update you on the government's legislative response.



If you would like more information, then please contact **Langton Clarke** by email or on 07 3239 2926.

Tax determinations—agribusiness schemes

Consequences

On 2 October 2009, the Australian Taxation Office (ATO) issued three draft tax determinations which cover the taxation consequences for investors in failed agribusiness schemes under various scenarios.

Issued in light of the Timbercorp and Great Southern collapses, the rationale for these tax determinations is to provide certainty for existing investments regarding the effect different scenarios will have on tax deductions already claimed.

The tax determinations are not specific to Timbercorp or Great Southern.

TD2009/D9

Draft tax determination TD2009/D9 addresses whether a change of responsible entity of a registered agribusiness scheme affects the tax outcomes for investors.

The ATO has confirmed the product ruling for a scheme will continue to apply provided the scheme continues to be carried out in accordance with the terms of its ruling. This includes being carried out under the management of an administrator, receiver or new responsible entity. The ATO confirms that the appointment of a new responsible entity, administrator or receiver does not, of itself, result in the implementation of a scheme in a materially different way to that described in the product ruling.

The draft ruling does state however, that if the appointment of the new responsible entity results in a change in the activities or work conducted under the various agreements that comprise the scheme, then the change of responsible entity may result in there being a material difference to the scheme ruling. The determination confirms the ATO's long held policy that a difference is material if it results in a tax outcome different to that set out in the product ruling.

TD2009/D10

Draft tax determination TD2009/D10 addresses whether the disposal or termination of an interest in a non-forestry scheme which arises as a result of circumstances outside of the control of the investor results in the denial of tax deductions previously allowed.

The determination concludes those deductions will not be denied. This is a useful ruling and confirms the position that, provided the intention of an investor at the time they invest is to remain in the scheme, they should not be penalised for disposing of an interest in circumstances beyond their control.

TD2009/D11

Draft tax determination TD2009/D11 addresses whether payment received by an investor in a non-forestry scheme on the winding up of the scheme is ordinary income under the tax laws. The determination says it is not, although it leaves open the prospect that it may be depending on what the payment is actually for.

As last year's Federal Court case definitively determined that an investor in an agribusiness scheme carries on their own business, amounts received for the sale of harvested produce from the operation of the scheme will be personal income and therefore assessable.

When a scheme ends and is wound up, money or other property that is part of the scheme assets remaining will be distributed to investors. If this was deemed to be on account of the disposal of harvested produce, then it would be income in the hands of the investors.

However, the determination provides that whilst an investor's interest may be the subject of certain capital gains tax events, this does not necessarily mean any money received will be capital proceeds **from the ending** of the interest (emphasis noted in the determination). Instead, it will be a distribution of the remaining scheme property to investors and as such, any payment is unlikely to be capital proceeds from the ending of the investor's agricultural business.

Conclusion

The draft tax determinations should assist investors in agribusiness schemes and their advisors to understand what tax consequences will flow from the failure of a scheme. McMahon Clarke Legal can provide advice about all aspects of the winding up of a scheme.



If you would like more information, then please contact **John Lane-Mullins** by email or on 07 3239 2922.

Winding up registered schemes

Winding up

Circumstances might arise in which a responsible entity decides that it is in the best interests of the members to wind up a registered scheme. The decision to wind up might be triggered by the insolvency of the scheme, or some other cause.

Once a decision has been made to wind up, the responsible entity must consider how this can be accomplished by having regard to the constitution of the scheme, and the *Corporations Act 2001* (the Act).

Three ways

There are three ways in which a scheme can be wound up as follows:

1. Section 601NB enables the members to take action to call a meeting to wind up a scheme. There is not an express right in the Act for a responsible entity of its own volition to call such a meeting. Unless the members choose to initiate that action, the responsible entity cannot rely upon this section to bring about the winding up.
2. Section 601NC provides that a responsible entity can wind up a scheme if it considers that the purpose of the scheme cannot be accomplished. The responsible entity must give 28 days notice to ASIC and each of the members, and they have the option to call a meeting of members to consider an alternative proposal. The responsible entity's reliance on this provision could be challenged in some cases, so if the circumstances facing the scheme

are likely to be controversial, relying on this ground to wind up the scheme could expose the responsible entity to liability.

3. Section 601ND enables the responsible entity to apply to the court for a winding up order on the basis that the winding up is just and equitable. This is a more expensive and time consuming option, but can be worthwhile if there are complex issues to be dealt with or the responsible entity feels it has conflicting duties that it cannot resolve. The court's imprimatur for the wind up could be valuable protection for the responsible entity.

Conduct of winding up

Generally, the responsible entity is required to wind up the scheme. This can be contrasted with the winding up of a company, in which the directors must hand over the affairs to a registered administrator/liquidator.

However, the Act gives the court power to appoint an external administrator if it thinks it is necessary, including for the reason that the responsible entity has ceased to exist or is not properly discharging its obligations in relation to the winding up.

In addition, the responsible entity can always appoint a registered liquidator or administrator to conduct the winding up on its behalf, and might choose to do so in circumstances where it is concerned its conduct might be the subject of some criticism by members. External controllers are in a safer position to rely on section 601NC referred to above, particularly if the responsible entity is insolvent.

Case study

The 2009 Victorian case of *Re Environinvest* dealt with the winding up of both registered managed investment schemes and excluded offers in relation to agricultural projects. There were a number of schemes established over different time periods, and to complicate matters, the responsible entity was insolvent.

The case highlights the difficulties that a court is faced with when it is required to wind up a complex series of interrelated agricultural schemes which are being conducted as one farming enterprise. In particular, the court had to try to unravel exactly what assets are comprised in an agricultural scheme, including the intangible things like the contractual rights and obligations created by the scheme documents.

A summary of some of the principles applied by the court is as follows:

1. The crucial consideration in any application to wind up a scheme is to identify what is to be wound up. The court said as follows:

It is the scheme, not merely scheme property, that is the subject of the order. The scheme is not an entity. Although there are similarities, it is not the same process as terminating a trust or winding up a partnership.

The scheme is defined by the constitution and the project documents, which create relationships between the parties. The project

documents include the leases, management agreements, powers of attorney and 'any other documents' required to be entered into by a Grower to hold an interest in the Project.

Add to that mix the "project property" or "scheme property", as defined in the constitutions, and the scheme begins to take shape as a series of agreements, arrangements and undertakings with defined relationships, objectives, inputs and outcomes. Thus, the scheme to be wound up includes, but is not limited to, scheme property.

2. The court accepted the "broad position" adopted by the growers which was that the growers were the owners of the trees. In fact, as ASIC pointed out, this was a necessary requirement at the time in order to meet the requirements of the Australian Taxation Office taxation ruling for agricultural schemes (which enabled scheme expenditure to be an allowable deduction against income). For that reason, there was an acknowledgement in various project documents that the trees were owned by the growers. However, the court accepted ASIC's submission that the effect of a winding up order is to give the scheme liquidator power to realise property that is inherently part of a scheme (including the trees) even if the project documents say legal title in the trees rests with individual growers. Contributions of money made by the growers were applied to the preparation of the land, the purchase of seedlings, and the planting and maintenance of the seedlings. The trees were therefore property derived from contributions, and were scheme property.

Advice

A decision to wind up a scheme will normally be a difficult one. Once made, a responsible entity needs to ensure that the implementation of the decision is done in accordance with the Act. This can be complex, particularly if there are multiple interrelated schemes. McMahon Clarke Legal can provide advice about all aspects of the operation and winding up of schemes.



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

Statutory novation on change of responsible entity

Novation

When the responsible entity of a managed investment scheme changes, the *Corporations Act 2001* (Act) provides for certain rights and obligations of the former responsible entity to be automatically transferred to the new responsible entity. Similarly, documents to which a reference is made to the old responsible entity are automatically taken to be a reference to the new responsible entity.

The intent of these provisions, often referred to as the statutory novation provisions, is to provide for the ongoing operation of the managed investment scheme notwithstanding the change of responsible entity. It would be impractical and unnecessarily burdensome for the new responsible entity to negotiate new contracts upon the change of responsible entity.

Rights, obligations and liabilities

Upon a change of responsible entity, the rights, obligations and liabilities of the former responsible entity in relation to the scheme become the rights, obligations and liabilities of the new responsible entity. There are exceptions to this provision (such as any rights of the former responsible entity to be paid fees for the performance of its functions and to be indemnified for expenses it incurred before it ceased to be the responsible entity).

Documents

The Act also provides that if the responsible entity of a scheme changes, documents to which the former responsible entity is a party in which a reference is made to the former responsible entity that are capable of having effect after the change of responsible entity has effect as if the reference to the former responsible entity were in fact a reference to the new responsible entity.

While this section is not expressed to be limited to documents relevant to the particular scheme, it has been held by the Federal Court that such a limitation should be implied.

Application

The broad drafting of the provisions of the Act leave room for some uncertainty as to what rights, obligations, liabilities and references in documents carry across to the new responsible entity. For instance, there may be a fine line between what matters are *in relation to the scheme* and what matters are not. The Federal Court, in finding that the words *in relation to the scheme* are to be interpreted broadly, found that a charge given by the former responsible entity of a scheme securing a guarantee of the scheme landowner's obligations under a loan agreement was a document to which the statutory novation provisions applied and the charge was taken to be enforceable against the assets of the new responsible entity, including assets held on trust for scheme members and its personal assets.

When dealing with the handover of a scheme from one responsible entity to another, issues almost inevitably arise in respect of the application of the statutory novation provisions to certain agreements, rights or documents. There may also be a question as to whether the incoming responsible entity takes on any liability of the former responsible entity for defect in the scheme's prospectus or product disclosure statement.

The application of these provisions is not a well settled area of law. We are aware of two cases in the Federal Court in Sydney where the application of these provisions to different rights, obligations and liabilities is being considered and judgment will be handed down shortly.

Conclusions

The broad manner in which the statutory novation provisions have been drafted make it important to consider the application of the provisions to every right, obligation, liability or document that could be said to be *in relation to the scheme*. Issues may even arise in respect of the new responsible entity's right to be paid fees under the scheme documents, particularly if the scheme documents contain contractual rights or obligations that could be said to be personal to the former responsible entity. Great care must be taken when conducting due diligence relating to the take over of an existing scheme.

We are experienced in dealing with these issues in the due diligence stage and in conducting litigation concerning the application of the provisions.



If you would like more information, then please contact **Nathan Shaw** by email or on 07 3239 2947.

Financial Services Modernisation Act 2009

The *Corporations Legislation Amendment (Financial Services Modernisation) Act 2009* (Cth) (Modernisation Act) received royal assent on 6 November 2009.

The Modernisation Act provides a number of new regulatory measures. Among other things, the Modernisation Act introduces the following:

1. The requirement for trustee companies to hold an Australian financial services (AFS) licence covering the provision of the relevant trustee services.
2. The requirement for margin lenders to hold an AFS licence and comply with general conduct standards.

3. The creation of a register of debenture trustees, as well as the alignment of all retail debentures and promissory notes so that they are subject to the consumer disclosure and protection measures currently applying to debentures.



If you would like more information, then please contact **John Lane-Mullins** by email or on 07 3239 2922.

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