



Investment & Financial Services Association Ltd

**Response to ASIC Consultation Paper 84
Managed Investment Schemes:
Withdrawal rights and scheme liquidity**

Dated: 29 August 2007

INTRODUCTION

The mortgage trust sector is very competitive and increasingly diversified in terms of financial product offerings. Every mortgage trust has a risk profile that is different – not all mortgage trusts are the same and not all retail financial products associated with real property are mortgage trusts.

As with any investment, a higher return is often a signal that it is an inherently riskier investment and all investments are subject to economic, market, credit and operational risk. The approach underpinning the operation of the *Corporations Act 2001* (the **Act**) is that there must be sufficient disclosure as would allow a reasonable person to make an informed investment decision. Customer understanding, regardless of the clarity of the disclosure or explanation given, is a significant challenge to both industry and the regulator. IFSA recently updated its Guidance Note for mortgage trusts, with a view to enhancing understanding about the operations and risks in this sector (Attached).

IFSA believes that ASIC, in its deliberations about mortgage fund withdrawal rights and scheme liquidity, should make a distinction between “conservative” “hybrid” and “high yield” mortgage funds and non-mortgage funds. While regulatory requirements may benefit from tightening in respect to high yield mortgage funds and certain non-mortgage financial products, a more prescriptive regulatory framework for all pooled mortgage schemes is not warranted.

If the proposed Guidance is issued in prescriptive terms and with general application, it will impact the operations of all mortgage schemes. Such Guidance could be detrimental particularly to well established schemes with a proven track record over more than 20 years that have operated without failure through the full range of economic and market conditions. If the Consultation Paper (**CP**) is issued in its current form it will negatively impact mortgage scheme operations and will diminish investment returns to scheme members.

Statutory references are references to the Corporations Act 2001 unless otherwise specified.

A. RESPONSE TO SPECIFIC QUESTIONS

Question 1.1: Are there any other matters concerning the rights of investors to withdraw that should generally be disclosed in a PDS?

We note the matters referred to in paragraph 1.3 of the CP and agree that a Product Disclosure Statement (**PDS**) would be expected to contain:

- (a) information about the ability of members and investors to withdraw from a scheme if the scheme is liquid or illiquid;
- (b) the withdrawal period that will generally apply where the scheme is liquid;
- (c) information about the maximum withdrawal period under the constitution;
- (d) information about any withdrawal suspension powers;
- (e) the legal requirements under Part 5C.6 where the scheme is illiquid; and
- (f) significant risk factors that may effect liquidity.

In relation to paragraph 1.3 (a) of the CP, while we agree that a PDS should provide objective information on matters that may influence scheme liquidity, it is not a requirement of the law to make a prospective statement on the future prospects of liquidity of the fund. Additionally, in practice, where it is a feature of the fund that a withdrawal facility is offered to members on a continuous basis, fund liquidity is managed to meet that objective and, it would generally only be the occurrence of extraordinary circumstances that would result in a scheme becoming illiquid as defined in section 601KA(4) of the Act. Accordingly, we believe that a PDS does not have to disclose current and future prospects of liquidity.

Where a PDS discloses the general timeframe in which withdrawal requests will usually be met, it is not necessary for a PDS to also specifically comment on current and future liquidity. The responsible entity of the scheme (**RE**) must have a reasonable basis for specifying a timeframe other than the maximum period specified in the scheme constitution, and must be confident that they can comply with any such representation on an ongoing basis.

In relation to paragraph 1.3 (b) and (c) of the CP, it is not appropriate to seek to introduce somewhat nebulous concepts such as “realistic possibility” when seeking to differentiate liquid from illiquid schemes. The Act is very clear in specifying that the obligation on the RE is that it must have a reasonable expectation that scheme assets can be realised within the period specified in the scheme constitution (section 601KA(5) and (6)).

General comments.

The rights of scheme members to withdraw from the scheme must be set out in the scheme constitution and must be fair to all members (section 601GA(4)). The Act requires the scheme constitution to specify member rights to withdraw and to set out

the procedures to apply where the scheme is liquid or is not liquid (sections 601KA and 601KB).

PDSs will contain information on withdrawal rights because that information would materially influence any decision to acquire an interest in a scheme (section 1013E). PDS statements on scheme liquidity and corresponding withdrawal rights are based on “normal” market conditions. We accept that the RE should consider disclosing what would happen in the event of a significant event/disruption but, as this is “unknown” and usually outside of the RE’s direct control, the RE usually does this by:

- (a) disclosing their right of suspension (as provided for in the scheme constitution);
- (b) extending the period for processing withdrawals to the maximum permitted under the constitution; and
- (c) explaining the circumstances in which a scheme would be regarded as illiquid and the consequences.

Industry does not dispute that member withdrawals are generally available within the time period specified in the scheme constitution and that schemes are able to, therefore, offer a continuous withdrawal facility on the basis that the scheme is liquid. Part 5C.6 was drafted to allow such an arrangement and to ensure that where a scheme became illiquid that a rush on a scheme was avoided and all scheme members were treated fairly. The management of liquidity is a matter for the RE.

There are, in our opinion, a number of specific areas that could assist investors and scheme members deal with procedures for making and dealing with withdrawal requests. In this regard, we consider that useful client information would include information:

- (a) on the scheme policy on withdrawal of funds, in both liquid and illiquid schemes should be available to scheme members on request;
- (b) that withdrawal applications are processed in date order received;
- (c) that the RE of the scheme treats members holding interests in the same class equally and members of different classes fairly (section 601FC(1)(d)); and
- (d) that withdrawal requests in liquid schemes could be delayed (but within the maximum period specified in the scheme constitution) in specified circumstances. Such circumstances would include:
 - (i) a material change in the quality of the underlying loan (or asset) book;
 - (ii) a change in market conditions generally affecting the asset class;
 - (iii) a run on the scheme; and
 - (iv) a run on mortgage schemes generally.

Such information could be referred to in the PDS and/or incorporated by reference into the PDS.

It is also important to note that RE's are bound by the terms of both the relevant constitution and the PDS applicable to a fund. A statement that, *generally* withdrawals are met within a certain period (being a period that is shorter than the maximum period allowed under the constitution) is not a guarantee that withdrawals will always be paid in the shorter period.

Question 1.2: Are there any other factors that should be considered when determining whether there are reasonable grounds for a statement about expected future withdrawal periods?

Twelve items are identified at paragraph 1.11 as being relevant factors to be considered in establishing reasonable grounds for a statement of expected future withdrawal periods. The list is expressed to be non-exhaustive.

While IFSA acknowledges that a range of factors will be taken into consideration where a withdrawal policy is determined, we are fundamentally opposed to any type of prescription of the matters that should be taken into account.

It is also important to note that some of the matters identified at paragraph 1.11 are problematic and that we do not believe that a requirement to include a statement as to "expected future withdrawal periods" in a PDS should in effect be mandated.

Factors that an RE may have regard when considering withdrawal periods include:

- existing cash levels;
- size of the fund;
- historic withdrawal timeframes and withdrawal levels;
- the availability to call upon liquidity facilities to meet withdrawal requests;
- the availability of liquidity through the maturity profile / discharge rate of the existing loan book to meet withdrawal requests;
- the ability to assign/sell loans to a third party to make funds available to meet withdrawal requests; and
- the availability of the responsible entity to provide a securitisation program to crystallise liquidity to meet withdrawal requests.

Establishing reasonable grounds

We believe that the list at paragraph 1.11 is too prescriptive and that use of complex models and forecasting will not provide any additional protection to investors, or indeed be useful to their investment decision. Under the current arrangements an RE may take additional steps, at their discretion, in circumstances where the prospects of illiquidity are high. Such steps are determined largely by the nature of the underlying scheme assets.

The following represent IFSA concerns with the factors identified in paragraph 1.11, particularly paragraphs 1.11(a), (b), (c) and (f).

- (a) While an estimate of the level of potential mortgage settlements and discharges on the loan book can be made, it is difficult to estimate future withdrawal periods or the factors determining the likely withdrawal periods or the likelihood of periods when there may be significant levels of withdrawals.
- (b) The estimation of future withdrawal periods is not a precise science as the level of withdrawals made may be influenced by a range of external factors not within the control of the RE.
- (c) An audit or review by an independent expert, for the purpose of establishing reasonable grounds as to statements about expected future withdrawal periods, is likely to introduce a false sense of security to an otherwise imprecise estimate.

An additional audit or independent expert review requirement would not materially improve investor protection – if anything an additional audit requirement would risk diverting manager resources to audit process, rather than the manager focusing on managing withdrawals in the interests of investors. However, if an independent audit is required it should be included as part of the annual audit compliance obligation and not a separate audit obligation.

- (d) We estimate the direct cost of a separate liquidity audit would be approximately \$50,000 per fund and possibly as high as \$100,000 per fund. This expense would either be borne directly by the fund or, in the event that operating expenses are paid out of responsible entity fees, it may be borne by unitholders indirectly as a result of an increase in relevant fees. In the event of a fee increase the additional costs of notifying existing investors and updating the PDS would also be incurred (and possibly borne by investors).
- (e) Modelling is extremely difficult given the range of factors that may need to be assessed and taken into account. For example, if a loan is in default, it may be more appropriate for the manager to put in additional funding in order to achieve a more positive outcome in the near future (particularly with respect to construction loans).
- (f) The production of a cash flow model should not be mandated where there are sufficient grounds for establishing a reasonable basis for forward looking statements regarding withdrawal periods. The utility of a cash flow model is questionable given the difficulty in forecasting the mortgage market and, relevantly for paragraph 1.1(b)(i) of the CP, considering that past performance information should not be relied on as indicative of future performance (ASIC RG 53, 168 and 170). It is not clear how a sensitivity analysis of any future cash flow model would be undertaken – given that the cash flow model itself would be based on various assumptions.

Question 1.3: Other than pooled mortgage schemes, are there any schemes that are marketed on the basis that withdrawal requests will be satisfied within a much shorter period than that specified in the Constitution? Are there any special considerations for these schemes?

Other schemes in which withdrawal requests may be satisfied within a shorter timeframe than as stated in the constitution may include infrastructure, private equity, unlisted property and hedge fund schemes.

We would expect that the relevant disclosure documents to disclose the risks associated with such investments, including the risk that the RE may not be able to meet withdrawals within the shorter timeframe, the risk of the fund becoming illiquid, and the consequences if this happened. As long as the risks are disclosed and liquidity managed, the operation of these schemes would be in compliance with the legal requirements. As with pooled mortgage schemes, we do not believe a prescriptive approach is appropriate because the risk profile of each scheme will differ and will depend on matters such as the nature of the assets held.

It should also be noted that there are schemes, particularly illiquid or fixed term arrangements, where the scheme constitution enables the RE to facilitate the transfer of member interests to another or a new member. In a fixed term scheme there is no right of redemption but a transfer of interests is possible.

If it is proposed to apply the approach set out in the CP more broadly to these types of schemes, broader industry consultation would be necessary as the focus of this CP is primarily on pooled mortgage schemes and the IFSA comments provided are largely limited to mortgage schemes.

Question 1.4: Are there any other factors that should be considered when determining whether a scheme is likely to be liquid for the purposes of Pt 5C.6

The factors set out in paragraph 1.13 (except paragraph 1.13(f)) are examples of the matters that may be relevant to the making of a statement about the likely future liquidity of a scheme. The extent to which these factors are relevant is influenced by the risk profile of the scheme.

As previously stated, an audit on liquidity (referred to in paragraph 1.13(f)) has, in our view, a tenuous connection to an assessment of liquidity. A prescriptive approach to a determination of the liquidity of a scheme is inappropriate because it may not be necessary to consider all factors (see response to Questions 1.2 and to 1.5) in the context of every pooled managed investment scheme.

Question 1.5: When is it reasonable to expect that the responsible entity of a pooled mortgage scheme would obtain an audit or independent review of its assessment of future withdrawal periods or future liquidity before making representations about these matters?

We do not believe that obtaining an audit or independent review of an RE's assessment of future withdrawal periods or future liquidity would generally be appropriate.

As an audit is based on measurable information it would be difficult to conclude that requiring the RE to obtain an audit of its assessment of future withdrawal periods would provide any significant added value to existing or prospective unit holders.

We would not expect the RE to require an audit or independent review of its assessment of future withdrawal periods. In our view, the determination of withdrawal periods is a core skill that falls within the expertise of a RE. However, there may be instances where the RE seeks to have an independent audit made in relation to the process or methodology it uses to assess its capacity to meet future withdrawal requests.

Question 1.6: What would be the typical cost of obtaining an audit or independent review to justify statements about expected withdrawal periods or future liquidity

It is difficult to quantify the cost and it would vary depending upon the scope of the review and the nature of the scheme, assets etc, and complexity of the model. Our best estimate is that the additional cost to scheme members would be between \$50K and \$100K pa.

It is important to note that, in addition to the direct cost of an audit, there may be indirect costs where an RE is required to increase its fees to cover the cost of the audit. This situation might arise where a RE has adopted the approach of paying normal operating expenses out of its fees.

Question 1.7: When is it reasonable to expect the responsible entity of a pooled mortgage scheme to notify members of a material change in current expected withdrawal periods or scheme liquidity? Is it sufficient to make this information available for example on a website or should it be drawn to members' attention? In what kinds of situation will a change in circumstances need to be disclosed under the Act?

Changes in circumstances

It should be sufficient for the general disclosure about liquidity and expected withdrawal periods to be made in the PDS, taking into account the nature of the

scheme assets. These statements are based on assumptions of “normal” market conditions. Again, it should be noted that a statement that, *generally* withdrawals are met within a certain period (being a period that is shorter than the maximum period allowed under the constitution) is not a guarantee that withdrawals will always be paid in the shorter period. It is generally indicative of the time, within a scheme, to process applications. Such statements are drafted in a manner so as not to require a supplementary PDS. They are, in other words, objective statements of fact.

If, however, there is a material change in expected withdrawal periods, this would be communicated to investors as soon as reasonably practical and there is an existing legal obligation for ongoing disclosure of material changes and significant events (section 1017B Corporations Act). Communication would be by e-mail, written advice and would be available on the RE’s website.

Factors that we would expect to be taken into account and communicated include:

- the reason for the change;
- the nature of the disclosure in the relevant PDS in relation to withdrawal periods, the liquidity of the fund, the responsible entity’s ability to suspend withdrawals, illiquidity, the consequences of illiquidity and the ability of the responsible entity to change the terms set out in the product disclosure statement;
- the period for which the change will apply;
- whether the change is positive or negative.

In the event of a materially adverse change in respect of an investor’s ability to withdraw from a fund or a materially adverse change to the liquidity of a fund, an RE should notify investors of such a change.

In relation to the disclosure to existing investors required by the Corporations Act, in our view the following provisions may (but this will depend on the particular circumstances) require disclosure:

- if the product is not an ED security – pursuant to the ongoing disclosure requirements in s1017B;
- if the product is an ED security – pursuant to the continuous disclosure requirement in section 675 of the Corporations Act (where the information would have a material effect on the unit price of the ED security); and
- pursuant to the periodic reporting requirements in section 1017D(5)(f).

In the normal course of business, existing investors are in practice usually provided with updated information on a monthly and/or quarterly basis. This update may take the form a newsletter and/or update letter and/or information on a website. Advisers are also provided with such updated information.

Question 1.8: Does the proposed guidance in this section about disclosure of scheme liquidity and withdrawal rights reflect current market practice?

Advertising and other representations

Subject to the following comments, we believe the proposed guidance in sections 1.17 and 1.18 of the CP reflects current market practice.

Advertisements may state the timeframe in which withdrawal requests are generally met. However, in our experience, this is more likely to occur in relation to advertisements for higher yielding mortgage funds and other higher yielding products. Also, in our experience, it is unusual for an advertisement to include specific information about future liquidity.

Advertisements are typically short. Accordingly, it is not possible to include in an advertisement all the information that is relevant to an investor's decision to invest. In our view, it is for this reason that the Corporations Act requires advertisements to include (as applicable) the disclosures in sections 949A and 1018A of the Act and requires investors to be referred to the relevant PDS and be told where a copy can be obtained.

As a result, a short advertisement to the effect (for example) that "withdrawals will generally be paid within 5 business days" (which is reasonably based) when taken with the disclosure required under sections 949A and 1018A may be adequate and not misleading or deceptive or likely to mislead or deceive at the time published.

Currently, it is also industry practice to issue reports (often monthly) about scheme performance and profile. These reports typically include disclosure about scheme assets, including the underlying commercial mortgage exposure, liquidity position, and historical performance. The reports typically contain factual information and do not comment on withdrawal periods which are properly made in PDSs or scheme constitutions.

Question 1.9: If any of our proposals do not reflect current market practice, please provide details of:

- (a) those aspects of our proposals that depart from current market practice; and**
- (b) the amount and nature of any additional costs that would be incurred by responsible entities in operating schemes in accordance with our proposal.**

As a general comment, the guidance is presented in a manner that will be interpreted by industry as prescriptive requirements.

We do not believe that a prescriptive approach to the factors that must be considered, or steps which must be taken to ensure compliance with the law, is appropriate.

Industry operates in a dynamic market and blind adherence to prescribed requirements can, in our view, reduce RE flexibility to changing economic conditions, be commercially detrimental and produce a false sense of security. The actual matters or steps an RE should take need to be determined in the context of the risk profile of the particular fund and the prevalent economic and market conditions.

The proposed guidelines would:

- (a) place greater emphasis on the monitoring of liquidity projections; and
- (b) effectively impose measures for the independent review or audit of liquidity measures.

As previously stated, the additional costs for independent review or audit are estimated to be in the range of \$50K to \$100K annually. A more detailed assessment would be required to estimate the immediate and ongoing costs. Where a RE is complying with its legal and constitutional requirements, the proposed changes will not produce any consumer benefit.

2. MONITORING AND MANAGING LIQUIDITY RISKS

Question 2.1: Should a responsible entity consider the same matters when monitoring liquidity risks as it needs to consider when making representations about the future liquidity of a scheme or future withdrawal periods that will apply to the scheme?

Generally mortgage scheme liquidity is monitored on a daily or weekly basis.

The factors that are taken into account, however, will depend on the risk profile of the particular fund and would generally include the same or similar matters as would be taken into account when considering *general* withdrawal periods. Comments made in relation to Questions 1.2 to 1.6 apply equally in this context.

The following specific comments are made on the satement made in the following paragraphs of the CP:

Paragraph 2.3: ASIC has indicated that for a responsible entity to properly perform its duties it would need to (amongst other things) ensure that members are kept adequately informed about any material change to the liquidity of the scheme or liquidity risks. While there is no express requirement to this effect in the Act, we agree that in relation to existing members, notification to members is required where the change is materially adverse to the interests of members.

As stated in response to Question 1.8, it is typical industry practice to issue monthly reports about scheme performance and profile. These reports include disclosure about scheme assets, including the underlying commercial mortgage exposure, liquidity position, and historical performance.

Paragraph 2.4: We are in general agreement with the comments in this paragraph. However, we note that liquidity risk is not simply a function of a short withdrawal period and the time needed to realise mortgage loans. Other factors such as cash reserves, size of the fund, historical withdrawal levels and market conditions are also relevant.

Paragraph 2.5: PDS withdrawal statements are generally drafted in a factual manner reflecting the legal requirements and changes to the status of the scheme from liquid to illiquid would not affect the PDS disclosure. Status changes would generally be notified to members and advisers either in writing, electronically or via the RE website.

It is not industry practice for a RE to assess the liquidity of the scheme each time a member makes a withdrawal request. Rather, REs determine the liquidity status of the scheme by monitoring daily cash levels, deal flows (e.g. outflows as a result of the need to fund loans and anticipated inflows as a result of investments and mortgages being discharged), withdrawal request levels and amounts in aggregate needed to meet withdrawal requests. Consequently, in our view the law does not require the RE to consider whether the fund is liquid each time a member makes a withdrawal request. It may, however, be appropriate to review fund liquidity where a withdrawal request is for a significant amount by reference to cash reserve levels or fund size.

An RE manages on an ongoing basis the overall risk of the portfolios, including liquidity risk. This includes daily reviews of the valuations, potential settlements and discharges and known applications and withdrawals. Some RE's may maintain a stand-by liquidity facility to ensure that liquidity requirements are met on an ongoing basis.

For a large, widely held scheme it would not be practical nor efficient to monitor liquidity each time an individual member makes a withdrawal request. The type and frequency of liquidity monitoring should not be prescribed but should apply on a risk based approach depending on the nature of the scheme.

Question 2.2: Are there any other steps that pooled mortgage schemes might take to manage liquidity risks?

Not so far as we are aware.

Question 2.3: Does the proposed guidance in this section about monitoring and managing liquidity risks reflect current market practice?

As stated in response to the earlier questions, an RE will have regard to a range of matters for the purpose of determining the status of the scheme. The following statements in the CP, however, do not reflect current market practice:

Paragraph 2.9 - There is a danger in assertions of the kind made in the last sentence of this paragraph because the best interests of a member can only be determined at the relevant time taking into account the facts at that time. In the circumstances outlined in this paragraph maintaining liquidity may not be in the best interest of members and the RE would need to consider this matter at the applicable time having regard to its overriding obligation to act in members' best interests.

Paragraph 2.11 - Where a fund is promoted as being able to meet withdrawal requests within a stated timeframe that is shorter than that stated in the constitution, it would be unusual for maintaining liquidity not to be in the best interests of members.

Accordingly, where the RE also reasonably believes that it can continue to meet reasonable levels of withdrawal requests within the shorter timeframes, it is not necessary to specifically consider the interests of continuing members before agreeing to process each withdrawal request within that shorter timeframe. However, if the RE is concerned about its ability to meet reasonable levels of withdrawal requests, the interests of continuing members would be paramount when determining what action to take in relation to withdrawal requests.

The law does not require specific matters to be considered by an RE in the management and assessment of a scheme's liquidity. A requirement to document these criteria in advance of an assessment is neither useful nor appropriate, especially when withdrawals are able to be paid out as a matter of course. Withdrawals occur daily in many conservative mortgage funds in the "shorter" time period set out in the PDS without materially adversely effecting existing unitholders.

Question 2.4: If any of our proposals do not reflect current market practice, please provide details of:

- (a) **those aspects of our proposals that depart from current market practice; and**
- (b) **the amount and nature of any additional costs that would be incurred by responsible entities in operation schemes in accordance with our proposals.**

See above.

Question 3.1: Should we grant relief to allow scheme constitutions to provide for multiple withdrawal periods? Would allowing multiple withdrawal periods raise any investor protection issues?

The legal restrictions at section 601KC should be modified only to the extent that it would permit withdrawals of different classes of member to operate concurrently.

Such a modification would be consistent with the general requirement for an RE to treat members of the same class equally and members of different classes fairly.

We also ask that ASIC clarify what it regards as “multiple withdrawal periods”. If the question is designed to address a different practice, it would be helpful for ASIC to advise the industry what it regards as “multiple withdrawal periods”.

Question 3.2 If relief is provided, what conditions should apply? Should the test for whether a scheme with multiple withdrawal periods is liquid be based on the shortest withdrawal period specified in the constitution? Would this be consistent with current market practice? If not please give details on the amount and nature of any additional costs that would be incurred by responsible entities in operation schemes in accordance with our proposals.

The test for liquidity should not be based on the shortest withdrawal period specified in the constitution because it may not be the most relevant measure of liquidity. The liquidity tests that apply will depend on the nature and operation of the scheme, and the provisions of the scheme constitution. The RE should disclose the withdrawal periods that apply in the PDS and disclose any restrictions.

B. COMMENTS ON EFFECT OF PROPOSALS ON COSTS & COMPETITION

If a prescriptive approach was adopted in the ASIC Guidance note a detailed assessment of direct and indirect costs, as well as competitive issues and general market impacts would need to be undertaken.