Principal and agent problems in Australian responsible entities

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Since 1998, the Australian funds management industry has seen the creation of the single responsible entity. The introduction of the single responsible entity unifies the role of trustee and investment manager in a legal entity for the purpose of managing investment funds. This paper argues that this dual role of the single responsible entity causes severe principal and agent problems in the Australian managed funds industry. As a result, the single responsible entity benefits the investment manager, but it comes at a cost and risk to investors. These costs are not visible during favourable economic times, but become more evident when investment market conditions deteriorate as evidenced during the 2007–2008 global financial crisis (GFC).

Introduction

The recent events of the GFC have highlighted concerns regarding the efficacy of the Australian Securities and Investments Commission (ASIC) licensed participants in the Australian managed funds industry. More specifically, the investment losses from several failed managed investment schemes (MIS) have put into question the legal design and viability of the single responsible entity (SRE) within the Corporations Act 2001, and its role to act in the best interests of investors. This paper reviews the historical evolution of the SRE and the justification for its existence. The conflicting roles within the SRE are considered through the classical economic concept of the principal-agent problem. In the light of this, it is argued that the creation of the SRE is an efficiently designed legal structure; however, it distorts the roles and functions within the three-party relationships between trustee, investment manager and the investor.

Overview of the Australian funds management industry

The laws and practices adopted in the global funds management industry are dominated by both corporate and unit trust law. Russell (2007) explains that in the company form, participants (shareholders) own shares in the firm that in turn own the underlying assets. In this structure, shareholders have no direct rights of ownership in the assets but, instead, possess rights arising from their ownership in the shares in the company. Under a trust structure, the legal owner of the underlying assets is the trustee, and the participants/members of the scheme are the beneficiaries of the trust and thus are the beneficial owners of the underlying assets. Both of these legal structures are employed in the Australian funds management industry (i.e., corporate structures are employed in listed investment companies [LICs] while trust structures are prevalent in managed investment schemes). The unique feature of the Australian funds management industry is the responsible entity that unifies the trustee role and investment manager into a single structure. This legal entity is unique within the Australian Corporations Act 2001 as it has not been developed or adopted in other countries. This, therefore, begs the question, how was the responsible entity developed in Australia?

Prior to the Corporations Act 2001, investment funds operated as collective investment schemes via the unit trust structure regulated under the previous prescribed interests schemes framework via Divisions 5 and 5A of Part 7.12 and Division 5 of Part 4 of the state Uniform Company Acts 1961 (Australian Treasury 2008). In the prescribed interest era, assets (i.e., property) were held by a trustee, and a separate company was appointed to manage these assets with the beneficial interest, in the fund being divided into units held in the trust structure (see Barrett 2008 and the Law Reform Commission 1993). Under this prescribed interest framework, the trustee (as in conventional trust structures) was appointed to act in the best interests of the investor. Under this legislative regime, the trustee appointed a separate entity to manage the assets of the investment scheme. In economic speak, this arrangement means that the investor (i.e., the principal) has beneficial interest in the fund managed by the trustee (i.e., the agent) who appoints a third party (another agent) to act as the investment manager of the unit trust.

The prescribed interest structure was generally successful until these investment schemes deteriorated into a legal dispute. The problem for the investor became who should be sued to recover losses in the event of poor investment decisions. The investor could sue either the trustee or the asset manager or both; however, the result became a cumbersome and complex process. Furthermore, asset managers with substantial funds under management argued that their large size of funds under management did not require the role of a trustee company within an investment scheme. The evolution in Australian funds management progressed with the introduction of the Managed Investments Act 1998 as part of Chapter 5C of the Corporations Act 2001. The Managed Investments Act 1998 (MIA) removed the requirement for an independent trustee. Under this legislation, the dual roles of trustee and asset manager could be unified into a single responsible entity (SRE). The separate roles of trustee and manager within an SRE raised concerns of adequate investor protection as the trustee of a unit trust is appointed to act in the best interests of the investor. However, at the same time, the SRE also acts in their self-interest as the investment manager of the unit trust. To address these investor protection concerns, ASIC introduced measures whereby a managed interest scheme is required to have a compliance plan and compliance committee.
within the Act if fewer than half of its directors are external directors deemed to be independent of the SRE. Alternatively, SREs with a majority of independent directors are not required to maintain a compliance plan and compliance committee.

The merging of both trustee and investment manager functions in an SRE provides an efficient legal structure in the Australian funds management industry; however, it comes at a cost to investors. As a consequence, the unification of these dual roles causes severe conflicts between these two important but separate functions within a responsible entity. How can an SRE act in the best interests of the investor as the trustee and, at the same time, act in its own best interest as the investment manager? The introduction of the SRE in Australian managed interest schemes has distorted the relationship between the trustee, the investment manager and the investor. To better understand this conflict, the economic concept of the principal–agent problem is reviewed.

Principal and agent framework

The economics and finance professions have long understood the rudimentary conflict between owners and managers of capital—more commonly referred to as the principal–agent framework. The founding father of economics, Adam Smith recognised the elementary conflict between owners and managers when he wrote:

*The directors of such companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which [owners] watch over their own (Smith 1776, p. 571).*

Put simply, owners of capital seek to maximise the profits of their firm or capital. When the owner cannot manage that capital, or wishes to appoint someone with greater expertise (or information asymmetry), the principal will appoint an agent who makes economic decisions on behalf of the principal. A principal–agent problem exists when the interests of the two parties differ in some way. As a consequence, agents tend to make decisions that are different to the decisions expected by the principal. This occurs because agents make decisions in their own best interests rather than those in the best interest of the principal.

As a result, this conflict exists in many principal–agent relationships in everyday life when an individual relies on the specialist expertise of an agent.

Some examples include:

**Principal**
- parents
- rate payers
- house vendors

**Agent**
- babysitters
- mayor
- real estate agents.

Do these agents always act in the best interest of their principals?

The study of the principal–agent problem in finance has centred on the study of corporate financial decision making in the seminal work of Jensen and Meckling (1976). Corporate managers are the agents employed to maximise the wealth of the shareholders who are the principals. The principal–agent problem occurs when the agent behaves in a way that is not in the best interest of the principal. Examples include reduced work to enjoy leisure time, hiding corporate inefficiency to avoid loss in rewards and corporate excesses to enhance the personal wealth and leisure of the corporate manager.

Other researchers such as Drew and Stanford (2003) have examined this conflict in an Australian setting between the investors (the principal) and providers of financial services (the agents) in the superannuation (i.e., pension) industry. The variety of principal–agent conflicts in superannuation mentioned in Drew and Stanford (2003) include the relationships between:

(i) the super member (the principal) and the trustee;
(ii) the trustee and their advisor (i.e., the asset consultant);
(iii) the trustee and the investment manager.

For example, a trustee may avoid or delay the termination of services of an underperforming investment manager as it reflects poorly on the trustee’s initial decision to hire the fund manager in the first place. It may be in the best interest of super members (the principal) that the trustee (agent) fires the current fund manager (another agent) due to poor performance; however, the trustee may not do so in order to preserve their own interests ahead of the interests of the principal. This type of behaviour has been documented in Goetzmann and Peles (1997) who revealed the lack of response to firing underperforming managers in US mutual funds.

The principal–agent framework can also be employed to describe the conflicts inherent in the Australian funds management industry. Under the previous prescribed interest regime, the investor as principal would engage a trustee as an agent with expertise in the fiduciary role of an investment scheme. The trustee would then appoint an entity to manage the underlying assets or property in the investment scheme. Under this structure, the investor is the principal who appoints the fiduciary trustee as agent who in turn employs the investment manager as another agent to manage the assets of the investment scheme.

Under the current Corporations Act 2001, the investor as principal would engage an SRE functioning in the unified role of both trustee and investment manager. The SRE as the trustee performs a fiduciary role and acts in the best interests of the investor. At the same time, the SRE also acts as an agent in their role as investment manager of the investment scheme. It is abundantly clear that severe conflicts exist between the functions of the trustee and investment manager roles within an SRE. In a poorly performing managed investment scheme, does the SRE act in the best interest of its unit holders (the principal) and terminate its mandate as investment manager (agent) or, alternatively, does the SRE act in its own best interest and avoid termination to continue receiving management fees? This conflict is at the heart of the principal–agent problem in the SRE. The question remains whether the ASIC regulated compliance plan and compliance committee has been a practical solution to protect investors from these principal–agent conflicts?
The recent principal–agent problems with SREs in Australian MIS such as Timbertcorp, MFS and Great Southern Plantations are empirical examples where the interests of the SRE as the investment manager were placed ahead of the interests of the principal. Table 1 summarises the details of the principal–agent problems in SREs of some recently failed investment schemes in Australia. However, these investment fiascos have not occurred without warning. In the past, several individuals and entities have made various attempts to highlight the inherent conflicts within an Australian SRE structure. These concerns were on the whole ignored to the detriment of the Australian investment public. The following early warning signs of the principal–agent problems were identified prior to the unfolding events of 2007–2010.

Some of the early concerns were voiced three years after the 1 July 1998 introduction of the MIA with the Australian Federal Government ‘Review of the Managed Investments Act 1998’. The objective of the MIA was to protect investors’ interests from inappropriate or poor management practices of scheme operators and the risk of fraud and dishonesty. In September 2001, the Trustee Corporations of Australia (2001) lodged a submission to this review arguing that the MIA provided serious flaws in the responsible entity design due to severe conflicts that may result in investment losses. The concerns from the Trustee Corporations of Australia (2001) submission were acknowledged, but never adequately addressed by the Review of the Managed Investments Act 1998. In 2008, the Review of the Managed Investments Act 1998 concluded that the MIA and the unified role of the SRE were adequate enough to protect investor interests.

Another early warning sign on the fundamental flaw in Australian responsible entities came from Harris (2004). The principal–agent problem develops into a greater level of conflict and complexity in the event of an insolvent SRE. The contribution by Harris (2004) highlights the flaw in the MIA when the SRE exhibits competing interests between the SRE, investors (or scheme members), scheme creditors, general creditors and any external administrator of the scheme in the event of the winding up of a SRE. Favourable economic conditions since 1998 have hidden the underlying design weakness of the unified structure of the SRE. It is during the recent financial market turmoil that the flaws in the underlying design of the SRE have been exposed. With rising asset markets from the late 1990s to mid-2000s, the principal–agent conflicts between the trustee, investment manager and investor were not a concern for ASIC. The dual roles of trustee/investment manager in an SRE would eventually be tested in the downturn that occurred with the unfolding credit crisis in 2007 to the full blown GFC in 2008. The recent MIS failures of Westpoint, Great Southern, Timbercorp, Fincorp and MFS provide substantial empirical evidence to demonstrate that legislative reform in the design of SREs is required to improve investor protection. Trust Company Limited (2009) view the recent MIS failures caused by the conflict between the principal and agent as lending support for legislative reform in SREs. Others including Barrett (2008) argue that an insolvent responsible entity introduces a legal quagmire between corporate law and trust law that has yet to be adequately addressed in Australian legislation.

Responsible entity reform

The principal–agent conflicts in SREs raise concerns regarding the future viability of this regulatory structure given the events of the GFC. The efficiency gains from the unification of the trustee and investment manager roles in the SRE come at a cost of poor investment decisions being made (by the agent) that are not in the best interests of the investor or principal. The estimated billion dollar losses summarised in Table 1 highlight the catastrophic investment decisions that may have been avoided if the unified role of trustee and investment manager remained separated. It is clear that SREs fail in their duty to act as trustee when they execute poor investment decisions in their role as investment managers. These catastrophic investment decisions occur to the detriment of the principal, the investor. It is clear that the introduction of the SRE has removed the effectiveness of the trustee role in this unique Australian legal structure.

<table>
<thead>
<tr>
<th>Name</th>
<th>MIS Investigators</th>
<th>SRE:</th>
<th>Estimated Losses:</th>
<th>Number of Investors:</th>
<th>Notes:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timbertcorp Primary Infrastructure Fund (TPIF)</td>
<td>Orchard Investments Management Limited (OIML)</td>
<td>TPIF</td>
<td>$61.5 million</td>
<td>14,500 MIS Investors</td>
<td>ASIC launched legal proceedings against the directors of the Westpoint Group and WML.</td>
</tr>
<tr>
<td>Fincorp Diversified Property Fund (FDPF)</td>
<td>Fincorp Managed Investment Limited (FMIL)</td>
<td>FDPF</td>
<td>$37.9 million</td>
<td>201 million</td>
<td>ASIC launched legal proceedings against MFSIM and former officers of the MIS Group in December 2009.</td>
</tr>
<tr>
<td>Various Westpoint based MIS including Paragon Syndicate, Fair Syndicate &amp; Income Fund.</td>
<td>Westpoint Investment Management Limited (WIML)</td>
<td>WIML</td>
<td>$386 million</td>
<td>4000</td>
<td>ASIC commenced legal proceedings against the directors of the Westpoint Group and WML.</td>
</tr>
</tbody>
</table>
This paper provides four independent legislative solutions to minimise the fundamental flaws of the SRE caused by the inherent principal–agent conflicts. Some of these policy recommendations are relatively easy to enact while others require structural legislative reform:

1. Introduce new legislative reform that ensures that responsible entities of a scheme are independent from the investment (or scheme) manager as recommended by Atkin and Bryant (2009). This policy outcome is the most practical recommendation that would require a minor amendment to the Corporations Act to ensure the dual roles of trustee and investment manager are separated.

2. The second policy recommendation requires structural legislative reform. This alternative solution requires amendments to the Corporations Act, which would terminate the current responsible entity (RE) structure and substitute it with the traditional framework of a separate trustee and investment manager. This recommendation would require a restructure of the Corporations Act.

3. The third policy recommendation is to adopt legislation that provides MIS investors with similar rights as the shareholders of the RE itself. This legislative reform would mean that investors can more carefully monitor their agents (i.e. the RE) through more transparent disclosure of contingent liabilities being borne by the RE. The difficulty under this type of legislative reform is the nature of rights that investors hold under this type of corporations law reform.

4. The fourth and final policy recommendation is to quarantine or separate the financial statements of the RE to ensure that the liabilities of the MIS and the RE entity itself cannot be co-mingled under the same entity. This alternative remains a formidable challenge to amend corporate legislation to provide this recommendation.

Conclusion

The introduction of the SRE in to the MIA was designed to improve investor protection from the shortcomings of the less regulated prescribed interest regime. This paper argues that the structure and perceived merits of the SRE is fundamentally flawed on the grounds that the principal–agent problem in the MIS does not improve investor protection. While the efficient legal structure and benefits of the SRE were evident during the design and drafting of legislation, the true costs borne by investors were not clearly recognised until the recent investment market downturn.

In light of the inherent weaknesses in the current structure of RE legislation via the MIA, several minor and major policy recommendations have been proposed to improve investor protection by reducing principal–agent conflicts within investment structures. Policymakers must ensure that legislative reform is carefully drafted in order to address the principal–agent conflicts in the MIA without creating new negative effects or distortions in other areas of MIS legislation.

References

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