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MINIMISING EXPOSURE TO FUND MANAGEMENT FRAUD IN AUSTRALIA:

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I INTRODUCTION

Australia is one of the world's largest fund management markets with the third largest fund pool in Asia.¹ At 31 March 2014, Australian managed funds institutions held around \$2,338.8 billion worth of assets,² and the value of assets in superannuation funds alone is expected to exceed 160% of GDP by 2050.³ Therefore, confidence in the operation and regulation of the industry must be maintained.

Recently, Australians have suffered significant losses from financial frauds.⁴ Four years after the Trio Capital fraud (where investors lost an estimated \$123 million),⁵ the underlying weaknesses of the Australian funds management industry remain unaddressed. This research analyses the effectiveness of organisational and regulatory structures of the industry on fraud prevention. This involves examining corporate structures used in the industry, and applicable policies, laws and governmental agencies.

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¹ NSW Trade and Investment, *An overview of Funds Management in Sydney and New South Wales* (July 2013) <<https://www.business.nsw.gov.au>>.

² Australian Bureau of Statistics, *Managed Funds, Australia* (March 2014) <<http://www.abs.gov.au/ausstats/abs@.nsf/mf/5655.0>>.

³ Commonwealth Department of Treasury, *Review of the Trio Capital Fraud and Assessment of the Regulatory Framework* (2013) 5 <<http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Trio-Capital-fraud-Review>>.

⁴ In this paper, the term 'fraud' is used generically to describe the scandals Reviewed by the Regulatory Authorities and Courts of the relevant jurisdiction, that included schemes through which investors lost money by investing in securities that were either non-existent, mismanaged, or misappropriated to finance the lifestyles of the principals of a firm or when there was criminal fraud, civil fraud, dealing in securities without being registered, serious misrepresentations and other misconduct.

⁵ Commonwealth Department of Treasury, above n, 3, 10.

The research primarily focuses on the Australian funds management industry, whilst drawing comparisons with Canada, the UK and the US. This international comparison has twofold significance. Firstly, the structure and regulation of the overseas industry provides a useful point of comparison. Secondly, the use of offshore hedge funds indicates that analysis must consider the international context.

In Part II, general background on funds management including the meaning of ‘fraud’ and the ways it can manifest within the industry will be discussed. Part III considers the organisational structures of managed funds, and examines the various structures and legal liability of various entities and the use of offshore hedge funds to reduce legal liability. Part IV examines the funds management regulation, involving consideration of the mechanisms governing the industry. Part V examines specific cases of fund management fraud and the effectiveness of regulatory arrangements in detecting fraud.⁶ Part VI proposes reforms to the organisational and regulatory structures of the industry, drawing on policy considerations and examples of successful reforms in other jurisdictions. Finally, Part VII provides a summary and conclusion of the paper.

II BACKGROUND ON FUNDS MANAGEMENT AND FRAUD

The Australian Prudential Regulation Authority (APRA) defines fraud as, ‘the intentional misstatement of information to obtain financial benefits through improper, unauthorised or illegal actions.’⁷ The concept of ‘fraud’ therefore potentially applies to specific offences under Australian law.⁸ Fraud in the funds management industry poses a significant threat to public confidence due to its impact on victims’ wellbeing and its social and economic impact on the community.⁹

Fraud remains a real threat to the stability of financial institutions. What makes fraud in managed funds¹⁰ unique is its indiscriminate nature. While other instances

⁶ For example, the Trio Capital fraud in Australia and Portus Alternative Asset Management Inc. fraud in Canada.

⁷ Australian Prudential Regulatory Authority, *Superannuation: How to Reduce Fraud - A Best Practice Guide for Trustees* (2010) 6 <<http://www.apra.gov.au>>.

⁸ For example, offences under *Australian Prudential Regulation Authority Act 1998* (Cth), *Superannuation Industry (Supervision) Act 1993* (Cth), *Australian Securities and Investment Commission Act 2001* (Cth) and *Corporations Act 2001* (Cth).

⁹ Australian Crime Commission, *Serious and Organised Investment Frauds* (July 2012) <<http://www.crimecommission.gov.au/publications/crime-profile-series/serious-organised-investment-frauds>> .

¹⁰ The term ‘managed fund’ describes schemes that hold financial assets selected by a manager and held for the investors in the scheme: Pamela Hanrahan, ‘ASIC and Managed Investments’ (2011) 29 *Company and Securities Law Journal* 287, 288.

of investment crimes may focus on a particular type of security or group of investors, fraud in managed investment funds affects all investors types. The following section examines how fraud can occur within the funds management industry.

Since 2009, Australia has been a leader in funds management, particularly in the Asia-Pacific region, and has outpaced countries with much bigger investment pools. Many factors have caused Australia's success. One factor – Australia's regulatory framework – serves as a model for other countries. Despite the emphasis on 'red-tape', this framework means that investors have greater confidence in the industry. The greatest cause of Australia's success is the compulsory superannuation scheme that requires all working Australians to invest in a managed investment fund. However, the various types of funds available, along with the compulsory superannuation system, can enable a few fraudulent actors to wipe out investors' life savings.

Though Australia's regulatory framework is robust, it cannot eliminate every instance of misconduct. With emphasis on self-regulation, entities must mitigate risks by having adequate compliance measures in place when dealing with client funds. If a breach occurs, a fund's administrators must take measures to prevent losses. However, the nature of managed funds makes it relatively 'easy' for fraud to occur without suspicion. Though safeguards are in place to prevent misconduct, (see Part IV), these measures are sometimes inadequate because fraud can occur in many ways:

- misappropriation of client funds for personal gain;
- establishment of Ponzi schemes;¹¹
- unauthorised investments for personal gain or covering losses;
- intentionally false or misleading disclosure documents obscuring a fund's true performance.

Fraud requires intent to deceive, and those harbouring such intent find many opportunities when they have discretionary control of client funds. Several red flags can suggest misconduct:

¹¹ This is an investment plan in which recent investors' monies are used to pay earlier investors who make a redemption request, where no investment of client funds has occurred: see, Saul Levmore, 'Rethinking Ponzi-Scheme Remedies in and out of Bankruptcy' (2012) 92 *Boston University Law Review* 969, 970.

- Lack of independence for investment managers trading through affiliated dealers, without proper compliance processes;
- Untimely redemption requests;¹²
- Moving funds to jurisdictions with less-stringent controls;
- Lack of independent auditing;
- Manipulating valuations to inflate the value of assets to cover losses;
- Use of client funds by investment managers for personal trading; and
- Illiquid investments.¹³

III STRUCTURE OF THE FUNDS MANAGEMENT INDUSTRY

Managed funds in Australia generally adopt two corporate structures - trusts and companies.¹⁴ The fund's structure affects the obligations, duties and liabilities of stakeholders. As a result, funds are usually structured to achieve acceptable levels of regulation and exposure to taxation.¹⁵ This paper does not discuss which structure provides greater returns,¹⁶ but focuses on the level of security against misconduct and fraud that different structures provide. This section provides an overview of the two structures and considers the relationship between the fund, investors and fund manager, and other intermediaries - custodians, brokers, dealers, financial advisers and planners. It also examines how corporate groups minimise liability, and the potential conflict-of-interest issues such groups create. The section concludes by examining offshore hedge funds and retail investors' exposure to such funds.

A *Corporate Structure of Funds*

1 *Trusts*

¹² Depending on the liquid nature of the underlying assets in a managed fund, a liquid fund such as a hedge fund should be able to meet redemption requests within a reasonable period of time. An inability for a fund to meet redemption requests may indicate serious problems with the management of the fund.

¹³ Investing in a commodity or asset, which is difficult to price, as it provides an incentive to overvalue the investment to gain a higher commission or otherwise attract investors through inflated values.

¹⁴ Funds can also be structured in other ways, for example, partnerships and co-ownership schemes.

¹⁵ Lydie Pierre-Louis, 'Hedge Fund Fraud and the Public Good' (2009 - 2010) 15 *Fordham Journal of Corporate & Financial Law* 21.

¹⁶ See Joseph Warburton, 'Trusts versus Corporations: An Empirical Analysis of Competing Organizational Forms' 36 *Journal of Corporation Law* 183, 189; Joseph Warburton, 'Should Mutual Funds be Corporations? A Legal & Econometric Analysis' (2008) *Journal of Corporation Law* 746 and Mitheran Selvendran, 'Revisiting the Investment Corporation versus Investment Trust Debate: The Australian Legislature and a Tale of Forgone Returns' (2013) 31 *Company and Securities Law Journal* 24.

Funds structured as trusts are governed by the trust deed, general trust law and the State's *Trustees Acts*.¹⁷ Investors (beneficiaries) purchase interests (units) in the fund (trust), giving them an interest in the fund's property. Trust funds can be privately held or listed on the ASX. A trustee holds fund assets for the beneficiaries. The trustee must exercise reasonable care and skill,¹⁸ and sufficiently discharge this duty 'if [the trustee] takes in managing trust affairs ... precautions which an ordinary prudent man of business would take in managing affairs of his own.'¹⁹ Importantly, the relationship between a trustee and the beneficiaries is one of the recognised categories of a fiduciary relationship.²⁰ The trustee's fiduciary role therefore requires the trustee to act in the best interests of investors.

The trustee may appoint a manager to manage the fund's asset and investment decisions. The ability of a trustee to appoint a manager is subject to the trust deed. Importantly, the trustee acts as a source of independent oversight of a fund manager's conduct, providing added supervision.

2 Companies

Funds structures as companies are governed by the company's constitution, general company law and the *Corporations Act 2001* (Cth) (Corporations Act). Investors purchase an interest (shares) in the fund (company), which is a separate legal entity.²¹ Company structured funds can be privately held or listed on the ASX.²² Since the company is a separate entity, the fund's property is owned by the fund itself and the investors (shareholders) have no legal or beneficial interest in the property. As shareholders, investors have voting rights and may vote on important matters involving the board of directors, capital raisings, and major acquisitions. Arguably, investors in company structured funds have more input into the fund management - via voting rights - than investors in a trust.²³

¹⁷ For example, *Trustee Act 1925* (NSW), *Trusts Act 1973* (Qld), *Trustee Act 1958* (VIC). See also Paul Ali, 'Adding Yield to Stable Portfolios: Regulating Investments in Australian Hedge Funds' (2001) 19 *Company and Securities Law Journal* 414 for an examination of some of the difficulties that arise as a result of the application of general trust law to managed funds.

¹⁸ *Re Chapman* [1898] 2 Ch 763, 775 in Michael Pearce, 'Company Directors as "Super-Fiduciaries"' (2013) 87 *Australian Law Journal* 464, 466.

¹⁹ *Speight v Gaunt* (1883) 9 App Cas 1, 19 in Michael Pearce, above n 18, 466.

²⁰ 'A person who occupies a fiduciary position may not use that position to gain a profit or advantage for himself, nor may he obtain a benefit by entering into a transaction in conflict with his fiduciary duty, without the informed consent of the person to whom he owes the duty': *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 97 (Mason J).

²¹ *Salomon v A Salomon & Co Ltd* [1897] AC 22.

²² Australian Securities Exchange, (2014) *Listed Investment Companies and Trusts* <<http://www.asx.com.au/products/managed-funds/lics-lits.htm>>.

²³ It is important to note that, different classes of shares may have different voting rights. As a result, the level of input that investors have will depend on the particular fund.

The directors are responsible for the ongoing management of the fund, subject to the *Corporations Act*. The directors must exercise due care and diligence;²⁴ exercise powers in good faith for proper purposes;²⁵ and must not improperly use information.²⁶ The relationship between director and company is also a fiduciary one. Consequently, directors are prevented from making unauthorised profits and must avoid conflicts of interest.²⁷ Unlike trustees, directors are required to act in the best interests of the fund (company) and not the investors (shareholders). Investors in a trust structure therefore arguably have more protection, as the fiduciary duty is owed to the investors directly.

Funds structured as companies must comply with the reporting requirements of the *Corporations Act*. Financial reports must be prepared to accounting standards and give a true and fair view of the fund's financial position.²⁸ These reports must also be lodged with ASIC, (except by small proprietary companies or those limited by guarantee).²⁹ Transparency regarding the fund's financial position helps to discourage fraud and misconduct.³⁰ Financial reports also allow investors to assess the financial position and risks of a fund.³¹

The directors may appoint a manager to manage the funds asset and investment decisions. The directors usually have a general power of delegation under the company's constitution, and exercise independent oversight of the fund manager.

3 *Relationship between Fund and Investors*

This relationship usually takes one of two forms. Investors can either be owners of a fund or enter into a purely contractual relationship with a fund. With a trust-structured fund, investors may be beneficiaries and will be paid out by way of distributions from surpluses.³² With a company, the investors may hold shares in

²⁴ Section 180 of the *Corporations Act*.

²⁵ *Ibid* s 181.

²⁶ *Ibid* s 183.

²⁷ *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR; [1984] HCA 64, 27 - 28.

²⁸ Sections 286, 296 and 297 of the *Corporations Act*.

²⁹ *Ibid* s 319. A company is a 'small proprietary company' for a financial year if it satisfies at least 2 of the following conditions: (a) the consolidated revenue for the financial year of the company and the entities it controls (if any) is less than \$25 million; (b) the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is less than \$12.5 million; and (c) the company and the entities it controls (if any) have fewer than 50 employees at the end of the financial year: s 45A(2) of the *Corporations Act*.

³⁰ Kent Oz, 'Independent Fund Administrators as a Solution for Hedge Fund Fraud' (2009) 15 *Fordham Journal of Corporate & Financial Law* 329, 347; S. Van Berkel, 'Should Hedge Funds be Regulated' 9 *Journal of Banking Regulation* 196.

³¹ Stephen Dimmock and William Gerken, 'Predicting Fraud by Investment Managers' (2012) 105 *Journal of Financial Economics* 153.

³² Australian Securities Exchange, above n 22.

the company and be paid dividends. In either case, investors have ownership of the fund.

Alternatively, the investor/fund relationship can be contractual. The fund undertakes to provide investors with a specified return under the terms of a contract.³³ Here, investors have no ownership in the fund or property and are creditors of the fund. The characterisation as ‘creditor’ has ramifications for the duties owed to such investors and the ability of investors to recover funds in the event of insolvency. Where the fund is a trust, the trustee does not have a fiduciary responsibility to contractual investors. Where the fund is a company, investors hold none of the voting rights of shareholders. As such, investors with a contractual relationship are arguably in a weaker position than those with ownership stakes. However, in the event of insolvency, investors with a contractual relationship rank before the owners, and are therefore better off.

B *Fund Management Intermediaries*

There are several intermediaries with roles in the funds management industry: custodians, brokers, dealers, financial advisers and financial planners.

A custodian may be appointed to hold fund property. The custodian acts as a ‘gatekeeper’ responsible for the flow of assets. The ability of a trustee or directors to appoint a custodian depends on the trust deed or company constitution. The regulations impose minimum standards on the way in which the assets should be held.³⁴ As the holder of fund assets, any fraud or misappropriation by a custodial services entity would have a direct and serious effect on investors. The imposition of minimum standards ensures that investors ‘are not exposed to unnecessary risks.’³⁵

Dealers and brokers play a part in creating markets for the funds management industry. They can either trade on their own behalf or that of others. When acting for a fund, there may be an incentive to achieve short-term returns (for higher commissions), which may not be in the best interests of the fund or investors. Dealers and brokers trading on behalf of others are subject to more burdensome regulations. The level of regulation also depends on whether they act on behalf of retail or sophisticated investors. When acting for retail investors, regulatory

³³ Pamela Hanrahan provides the example of ‘enterprise’ type schemes (particularly agribusiness schemes) ‘[that are] often structured as a series of bilateral executor contracts between the investor, the scheme operator and various other entities’: see ‘ASIC and Managed Investment Schemes’ (2011) 29 *Company and Securities Law Journal* 287, 288.

³⁴ Australian Securities and Investments Commission, (November 2013) ASIC Regulatory Guide 133, *Managed Investments: Scheme Property Arrangements* <<http://www.asic.gov.au/rg>>.

³⁵ *Ibid* 4.

requirements are more stringent, as sophisticated investors are assumed to be better informed, and require less protection.

Financial advisers and planners provide advice and recommendations about financial products. They may act on behalf of investors or the fund. As with brokers and dealers, the regulation requirements will depend on whether they service retail or sophisticated investors.

C Corporate Groups

The fund, trustee, manager and intermediaries may belong to the same corporate group,³⁶ or they may provide their services through a corporate group structure. This may lead to conflict of interest and liability issues.

1 Conflicts of Interest

These may arise where a fund, trustee, fund manager and intermediaries are related entities forming part of one corporate group, and intra-group dealings are conducted.³⁷ There is a relationship between fraud and conflicts of interest.³⁸ For example, financial advisors may encourage investors to invest in a related party fund unsuitable for the particular investor. Alternatively, managers may overlook exorbitant fees or commissions charged by a related party trader or broker. Such intra group dealings are a cause for concern, given that the regulation of the industry relies on the oversight of independent actors.³⁹ Where intermediaries are related parties, their independence is clearly questionable and the interests of investors compromised.

2 Company Liability

The status of companies as separate legal entities provides incentives for corporate groups to ring-fence assets and liabilities in separate entities.⁴⁰ The group may be structured with different entity holding the assets, the liabilities and providing the services.⁴¹ If an entity becomes liable for misconduct or becomes insolvent, the fall-out can be limited to that particular entity. Significantly, Courts have been unwilling to lift the corporate veil and permit investors to seek recovery from

³⁶ Anil Hargovan and Jason Harris, 'Together alone: Corporate Group Structures and their Legal Status Revisited' (2011) 39 *Australian Business Law Review* 85.

³⁷ Honourable J J Spigelman AC, 'The Global Financial Crisis and Australian Courts' (2010) 84 *Australian Law Journal* 615, 618.

³⁸ S. Dimmock and Gerken, above n 31, 154.

³⁹ Pamela Hanrahan, above n 10, 300.

⁴⁰ Anil Hargovan and Jason Harris, above n 37, 87.

⁴¹ For example, in *ASIC v Elm Financial Services* [2004] NSWSC 859, the financial adviser Elm Financial Services Pty Ltd conducted its business through six related entities.

other group entities,⁴² making it difficult to hold the responsible entity liable. Regardless, the group structure may still ensure that the liable entity holds few assets, thereby reducing chances of recovery. Unfortunately, the investors suffer and find themselves ‘enmeshed in a web of multiple, interlocked contractual relationships with a number of companies associated with the manager.’⁴³

D *Offshore Funds*

Offshore funds are established in foreign jurisdictions, and regulated by the laws of that jurisdiction. Bollen notes that ‘[t]he international mobility of firms and customers creates the potential for regulatory competition.’⁴⁴ Thus, jurisdictions offering more favourable regulatory and tax conditions are popular places to establish funds.⁴⁵ Importantly, whether a jurisdiction is more ‘favourable’ is often considered from the perspective of the fund, rather than that of investors.

There are benefits to be obtained from investing in offshore funds. They provide increased diversification and lower operating costs when located in jurisdictions with lower compliance costs and tax liabilities. However, a major concern is the indirect exposure of retail investors. The risks result from less rigorous regulatory regimes and the difficulty of recovering funds in the event of fraud, misconduct or fund failure. The Trio Capital fraud provides a useful example of risks associated with offshore funds (see Part V).

Australians invest in offshore funds directly – acquiring an interest in an offshore fund itself - and indirectly - acquiring an interest in an Australian fund investing offshore. With indirect investments, investors may be unaware of their exposure to the offshore fund. Superannuation fund beneficiaries are one type of retail investors that can easily be exposed to offshore funds through indirect investments. This exposure is particularly problematic as superannuation contributions are mandatory and constitute Australians’ retirement savings.⁴⁶ Such exposure of retail investors suggests that the characterisation of retail and sophisticated investors may need re-examination.

⁴² See *Commissioner of Taxation v BHP Billiton Finance Ltd* (2010) 182 FCR 526; Anil Hargovan and Jason Harris, above n 37, 90.

⁴³ Honourable J J Spigelman AC, above n 38, 618.

⁴⁴ Rhys Bollen, ‘International Standard-Setting and the Regulation of Hedge Funds: Part II’ (2010) 28 *Company and Securities Law Journal* 370.

⁴⁵ See Paul Ali, ‘Funds of Hedge Funds and Fiduciary Investors’ (2004) 32 *Australian Business Law Review* 362, 363.

⁴⁶ The mandatory superannuation contribution rate is currently 9.25 per cent, however this is set to increase over the next 6 years to 12 per cent: Australian Taxation Office, (2014) *Introducing your Super* <<http://www.ato.gov.au/Business/Employers-super/In-detail/Changes-to-super/Introducing-your-super/>>.

IV REGULATION OF THE FUNDS MANAGEMENT INDUSTRY

This section provides an overview of regulatory authorities and statutes governing the funds management industry. It examines the regulation of managed investment schemes, superannuation funds and Australian Financial Services Licence (AFSL) holders.

Post-GFC, regulators appear more concerned with managing systemic risk in the funds management industry.⁴⁷ However, the prevention of fraud remains fundamental to any regulatory regime. This section therefore also examines the main provisions prohibiting fraudulent conduct, drawing comparisons with fund regulation in the UK and US.

A Regulatory Authorities

Regulation of the Australian funds management industry is administered by three agencies – ASIC, Australian Prudential Regulatory Authority (APRA) and the Australian Taxation Office (ATO). ASIC supervises funds by regulating managed investment schemes, corporate entities and the financial services sector.⁴⁸

APRA is the financial services industry prudential authority, responsible for the supervision of superannuation funds and their trustees under the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act). APRA adopts a supervisory approach primarily concerned with the risk profile of superannuation funds,⁴⁹ setting operating⁵⁰ and prudential,⁵¹ standards and monitoring compliance with those standards.⁵²

The ATO is responsible for self-managed superannuation funds (SMSFs) under the *SIS Act*. It is primarily concerned with ensuring that SMSFs comply with that

⁴⁷ Robert Bianchi and Michael Drew, 'Hedge Fund Regulation and Systemic Risk' (2010) 19 *Griffith Law Review* 6, 21. See also the introduction of the *Alternative Investment Fund Managers Regulations 2013* and the *European Union Directive 2011/ 61/EU* which seek to regulate the conduct of fund managers of hedge funds that hold assets of more than Eur 100 million or Eur 500 million in the case of unleveraged funds: European Commission, *Alternative Investments* (15 May 2013) <http://ec.europa.eu/internal_market/investment/alternative_investments>. The Explanatory Memorandum to the *Alternative Investment Fund Managers Regulations 2013* notes that the regulations aim to ensure greater transparency in the positions held by such funds.

⁴⁸ Commonwealth Department of Treasury, above n 3, 19.

⁴⁹ Commonwealth Department of Treasury, above n 3, 18.

⁵⁰ Sections 31, 32 and 33 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (*SIS Act*). The operating standards deal with matters such as persons who may contribute to the fund, the form in which benefits can be distributed to members, the investment of fund assets and the management of those investments.

⁵¹ Section 34C of the *SIS Act*.

⁵² *Ibid* s 34F.

act.⁵³ Unlike registered funds, SMSF's are responsible for protecting their own interests – hence the ATO's focus is on compliance as opposed to prudential supervision.⁵⁴

B *Corporations Act and Managed Investment Schemes*

1 *Managed Investment Schemes*

A fund defined as a 'managed investment scheme'⁵⁵ (MIS) must be registered with ASIC.⁵⁶ The definition of a MIS is broad and covers funds established under different structures.⁵⁷ Corporations, partnerships with more than 20 members that do not need to be incorporated and superannuation funds are specifically excluded from the meaning of a MIS.⁵⁸ A MIS that has more than 20 members or is promoted by a person in the business of promoting managed investment schemes must be registered with ASIC.⁵⁹ On the other hand, a MIS need not be registered if it is marketed only to sophisticated investors and does not allow investments by retail investors.⁶⁰

MIS registration entails minimum operating and disclosure requirements. Like companies, MISs must prepare and lodge financial reports with ASIC,⁶¹ ensuring greater transparency regarding the financial position and value of the fund. A registered MIS must also have a constitution and compliance plan. The constitution governs the acquisition of an interest in the scheme, the power and duties of the responsible entity, the rights of members and the winding up of the scheme.⁶² The compliance plan is operational and sets out measures that the

⁵³ Commonwealth Department of Treasury, above n 3, 18.

⁵⁴ *Ibid.*

⁵⁵ A managed investment scheme is defined under s 9 of the *Corporations Act* as a time share scheme or a 'scheme' with the following features: (a) people contribute money or money's worth as consideration to acquire rights or benefits produced by the scheme; (b) contributions are pooled or used in common enterprise, to produce financial benefits for members of the scheme; and (c) members of the scheme do not have day-day control over the operation of the scheme.

⁵⁶ Section 601ED(5) of the *Corporations Act*.

⁵⁷ Pamela Hanrahan explains that 'the definition of managed investment schemes operates as a residual category into which collective investments that are not otherwise regulated, and that are not structured as companies fall': see, 'Directors' Accountability in Funds Management Companies' (2007) 4 *FINISIA Journal of Applied Finance* 36, 37.

⁵⁸ Section 9 of the *Corporations Act*.

⁵⁹ *Ibid* s 601ED(1)(a) and (b).

⁶⁰ *Ibid* s 601ED(2).

⁶¹ *Ibid* ss 286 and 319.

⁶² *Ibid* s 601GA. The constitution is a legally enforceable agreement between the members and the RE: s 601GB of the *Corporations Act*. See also Australian Securities and Investments Commission, ASIC Regulatory Guide 134 *Managed investments: Constitutions*, which provides guidance on the requirements of a constitution.

responsible entity must establish to ensure compliance with the *Corporations Act*.⁶³ Copies of the constitution and compliance plan are lodged with ASIC,⁶⁴ which conducts surveillance checks to ensure compliance with these documents.⁶⁵

2 Responsible Entity

A registered MIS must be operated and managed by a responsible entity (RE) that is a public company.⁶⁶ The RE therefore combines the roles of the trustee and manager in the single entity.⁶⁷ It holds scheme property on trust for members⁶⁸ and must ensure that the property is clearly identified and separated from its own assets.⁶⁹ In addition, the RE must act honestly, exercise due care and diligence, act in the best interests of members, not misuse information and treat members holding the same class of interest equally.⁷⁰ ‘These duties are designed to ensure that scheme assets are not applied..., to the [RE’s] own purposes rather than those of the scheme.’⁷¹

Officers of a RE have similar duties to those of the RE.⁷² Employees are under the more limited duty to not misuse information or gain advantage from their roles.⁷³ Particularly, officers of the RE are required to take all reasonable steps to ensure compliance with the *Corporations Act*, the conditions of its AFSL, the constitution and compliance plan.⁷⁴

⁶³ The compliance plan deals with such matters as, the manner in which scheme property is held and the valuation of scheme property: s 601HA of the *Corporations Act*. Australian Securities and Investments Commission, ASIC Regulatory Guide 132 *Managed investments: Compliance plans* which provides guidance on the requirements of a compliance plan.

⁶⁴ Section 601EA of the *Corporations Act*.

⁶⁵ *Ibid* s 601FF.

⁶⁶ *Ibid* s 601FB and s 601FA.

⁶⁷ *Australian Securities and Investments Commission v ABC Fund Managers (No 2)* (2002) 20 ACLC 120, 34 in Pamela Hanrahan, ‘ASIC and Managed Investments’ (2011) 29 *Company and Securities Law Journal* 287, 299.

⁶⁸ Section 601FC(2) of the *Corporations Act*.

⁶⁹ *Ibid*; Australian Securities and Investments Commission, ASIC Regulatory Guide 133 *Managed investments: Scheme property arrangements*, which outline the minimum standards that the RE must meet when holding the assets of the fund: see above n 35.

⁷⁰ Section 601FC(1) of the *Corporations Act*. These duties appear to be a combination of the general duties of a fiduciary and those imposed on officers of a company under ch 2D of the *Corporations Act*.

⁷¹ Hansard, House of Representatives, *Managed Investments Bill 1997 Second Reading Speech*, Wednesday 3 December 1997, 11929-3.

⁷² Section 601FD of the *Corporations Act* requires officers of an RE to *Act* honestly, exercise due care and diligence, *Act* in the best interests of its members, not misuse information obtained as a result of its role as an officer of the RE. Pamela Hanrahan notes that the *Corporations Act* disturbs the general law position by requiring the officers of an RE to give preference to the interests of the members as opposed to those of the RE: see, ‘Directors’ Accountability in Funds Management Companies’ (2007) 4 *FINISIA Journal of Applied Finance* 34, 37.

⁷³ Section 601FE of the *Corporations Act* prohibits employees from misusing information obtained as a result of its role as an employee of the RE.

⁷⁴ In the Trio Capital fraud case, the directors failed to ensure that the RE complied with the *Corporations Act*. The directors failed to ensure that: (a) RE valued the property of the Astarra Strategic Fund at regular intervals in breach of s 601FC(1)(j) of the *Corporations Act*; and (b) the

A RE can appoint an agent to do anything it may do in connection with a registered MIS.⁷⁵ Therefore, the RE can delegate the fund management functions to a manager or the asset holding functions to a custodian.⁷⁶ In so delegating, it remains liable to the members of the MIS and is taken to have done or failed to do anything that the agent did or failed to do.⁷⁷ Such provisions recognise that the RE may lack specific expertise to perform certain functions, whilst also accepting that the RE should remain responsible for any wrongdoing by intermediaries.⁷⁸

C *Corporations Act and Australian Financial Services Licence*

The AFSL regime provides the overarching regulation of the funds management industry. Even a fund not required to register with ASIC will still be serviced, or managed by, an AFSL holder. A person providing a 'financial service' in Australia must hold an AFSL.⁷⁹ A person provides a 'financial service' if they provide financial product advice, deal in financial products, operate registered schemes or provide custodial or depository services.⁸⁰ Securities, superannuation interests, and interests in MISs are specifically financial products.⁸¹ REs, fund managers and intermediaries such as brokers, dealers, custodians, financial advisers and planners must therefore hold an AFSL.⁸²

An AFSL holder must provide services honestly and fairly, have adequate risk management procedures and implement adequate systems to manage conflicts of

fund's financial reports complied with the accounting standards and showed a true and fair value of the financial position of the fund in breach of ss 296 and 297 of the *Corporations Act*, see Australian Securities Investment Commission, *Enforceable Undertaking pursuant to Section 93AA of the ASIC Act* (given by David O'Bryen, document number 02744362, 24 August 2012)

<[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/027444362.pdf/\\$file/027444362.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/027444362.pdf/$file/027444362.pdf)>.

The remaining directors of the RE, Natasha Beck, Keith Finkelde, David Andrews and Rex Phillpott also gave enforceable undertakings, see ASIC Media Release, 11-182 MR *Remaining Trio former directors excluded from financial services industry for four years* (24 August 2011); ASIC Media Release, 11-133MR, *Former directors of Trio Capital prevented from working in the financial services industry* (4 July 2011) <<http://www.asic.gov.au/rg>>.

⁷⁵ Section 601FB(2) of the *Corporations Act*.

⁷⁶ *Ibid* s 601FB(4).

⁷⁷ Where a custodian holds scheme property, it must indemnify the RE against loss or damage that the RE suffers due to a wrongful or negligent *Act* and any amount recovered from the indemnity forms part of the scheme property: s 601FB(2) of the *Corporations Act*.

⁷⁸ The Second Reading Speech to the *Managed Investments Bill* acknowledged that 'it may be appropriate in certain cases for a responsible entity to be required to engage a separate custodian of scheme assets': see, Hansard, House of Representatives, above n 72, 11929- 4.

⁷⁹ Section 911A of the *Corporations Act*.

⁸⁰ *Ibid* s 766A.

⁸¹ *Ibid* s 764A. An interest in an unregistered MIS that does not satisfy any of the 3 requirements of an MIS will not be a financial product.

⁸² Certain superannuation fund related entities are exempt from the requirement to hold an AFSL, for example the trustee of a self-managed fund and certain dealings by the trustees of superannuation funds, such as the payment of benefits, see s 911A(2)(k) of the *Corporations Act* and regulation 7.6.01 of the *Corporations Regulations 2001* (Cth).

interest.⁸³ ASIC may also impose conditions on the key persons of the fund, reporting requirements and auditing requirements.⁸⁴ Importantly, an AFSL holder must make certain disclosures when providing services to retail clients through a Financial Services Guide⁸⁵ and Product Disclosure Statement.⁸⁶

An AFSL holder must notify ASIC of certain breaches of the *Corporations Act* and ASIC may conduct checks of the holder. ASIC does not review compliance by every AFSL holder, relying instead on random audits and consumer complaints to identify non-compliance.⁸⁷ This is arguably the most pragmatic approach to surveillance; it would be un-feasible for ASIC to audit every AFSL holder. Unfortunately, there is a trade-off, as this approach may result in fraud and misconduct remaining undetected.

D *Superannuation Industry (Supervision) Act and Superannuation Funds*

Funds that fall within the definition of superannuation funds are regulated under the *SIS Act*.⁸⁸ A registered superannuation fund requires a trustee⁸⁹ holding a Registrable Superannuation Entity (RSE) licence.⁹⁰ APRA issues RSE licenses, the primary focus being the integrity of the trustee. APRA imposes varying conditions on licensees, depending on whether the trustee is a body corporate, individual or group of individuals.⁹¹ A licensee must notify APRA of breaches of the licence conditions.⁹² As with MISs, regulation of superannuation funds relies on self-regulation by trustees and oversight by independent parties such as directors and auditors.

⁸³ Section 912A of the *Corporations Act*; Australian Securities and Investments Commission, ASIC Regulatory Guide 104 *Licensing: Meeting the General Obligations* and Australian Securities and Investments Commission, ASIC Regulatory Guide 181 *Licensing: Managing conflicts of interests*.

⁸⁴ Robert Bianchi and Michael Drew, above n 48, 10. These conditions enable ASIC to consider the type of fund that the RE or intermediary is involved with, and impose conditions that are suited to that particular type of fund.

⁸⁵ The Financial Services Guide contains information regarding the AFSL holder; the financial services it is authorised to provide; information about any remuneration, commission and benefits it will receive; and any associations or relationships that may influence the provision of services: ss 942B and 941A of the *Corporations Act*.

⁸⁶ The AFSL holder must provide a Product Disclosure Statement where it provides personal advice recommending a financial product; issues or offers to issue a financial product; and sells or offers to sell a financial product to a retail client: see ss 942B, 941A, 1012A, 1012B and 1012C of the *Corporations Act*.

⁸⁷ Robert Bianchi and Michael Drew, above n 48, 10.

⁸⁸ Daniel Mendoza-Jones, 'Superannuation Trustees: Governance, Best Interests, Conflicts of Interest and the Proposed Reforms' (2012) 30 *Company and Securities Law Journal* 297, 298.

⁸⁹ Section 19(2) of *SIS Act*.

⁹⁰ *Ibid* s 29J.

⁹¹ *Ibid* ss 29E and 29EA. For example an RSE licensee may be required to appoint an auditor who meets the requirements set out in the prudential standards.

⁹² Section 29JA of the *SIS Act*.

The *SIS Act* distinguishes between regulated superannuation funds and SMSFs. This framework ‘recognises that some Australians would prefer to take personal responsibility for their superannuation and would prefer to make investment choices for themselves via a self-managed superannuation fund.’⁹³ The trustees of SMSFs are not required to hold a RSE licence, or comply with the APRA operating and prudential standards. The ATO assists in regulating SMSFs to ensure legal compliance.⁹⁴ SMSFs therefore have less oversight and rely more on self-regulation with its accompanying shortcomings. This lack of oversight arguably makes it easier to conceal fraud or misconduct.

Trustees of registrable superannuation entities must act honestly, exercise skill, care and diligence, in the best interests of the beneficiaries and treat the different beneficiary classes fairly.⁹⁵ Trustees must also ensure that proper accounting records are kept.⁹⁶ Importantly, the trustee must keep its own assets separate from fund assets and implement the fund’s investment, insurance and risk management strategies.⁹⁷ Where the trustee is a body corporate, its directors are subject to similar duties.⁹⁸ Relevantly, although SMSFs are subject to less regulation, these obligations also apply to trustees of SMSFs and their officers.⁹⁹

E *Prohibition of Fraud and Misconduct*

Part II discussed the different ways fraud occurs in the funds management industry. This section focuses on the prohibition of fraud under the *Corporations Act* and *ASIC Act*, drawing on cases showing the practical application of the provisions.

1 *Fraud and the Corporations Act*

Part 7.10 of the *Corporations Act* deals with market misconduct and other prohibited conduct.¹⁰⁰ Relevant for this research are:

- section 1041E prohibits a person from making a false or misleading statement or disseminating false or misleading information;¹⁰¹

⁹³ Commonwealth Department of Treasury, above n 3, 7.

⁹⁴ *Ibid*, 14.

⁹⁵ Section 52 of the *SIS Act*.

⁹⁶ *Ibid* ss 35A and 35AE.

⁹⁷ *Ibid*.

⁹⁸ *Ibid* s 52A.

⁹⁹ *Ibid* s 52B.

¹⁰⁰ The *Corporations Act* also prohibits other forms of market misconduct in relation to financial products on a financial market operated in Australia. For example, market manipulation (s 1041A), false trading and market rigging creating a false or misleading appearance of active trading (s 1041B) and false trading and market rigging that maintains an artificial price (s 1041C).

- section 1041F prohibits a person from inducing another person to deal in a financial product by making or publishing misleading, false or deceptive information; the dishonest concealment of material facts; and the recording or storage of information which is false or misleading; and
- section 1041G prohibits a person from engaging in dishonest conduct in carrying on a financial services business.

Breach of these provisions is a criminal offence punishable by fine and imprisonment.¹⁰² Where the entities are companies, directors and officers may also be liable and directors may also breach their own director's duties.¹⁰³

For example, in the Trio Capital fraud, Shawn Richards (a director and agent of the RE of the Astarra Strategic Fund) was charged with breaches of section 1041G and 1014E of the *Corporations Act*.¹⁰⁴ It was alleged that Richards: made false representations to investors regarding certain investments in offshore funds; made false representations to the auditors of Trio Capital Ltd and the Astarra Strategic Fund; and failed to disclose certain relationships and personal financial advantages he received.¹⁰⁵

2 *Fraud and the ASIC Act*

Provisions of the *ASIC Act* prohibit misleading or deceptive conduct in the provision of financial services:¹⁰⁶

- section 12DA prohibits a person from engaging in conduct in relation to financial services that is misleading or deceptive or is likely to mislead or deceive¹⁰⁷

¹⁰¹ This only applies where the person either knows or ought to have known that the statement or information was false or misleading or where the person did not care whether the information was true or false.

¹⁰² Section 1311 and sch 3 of the *Corporations Act*.

¹⁰³ Michael Pearce, above n 18, 450.

¹⁰⁴ *R v Shawn Darrel Richard* [2011] NSWSC 866, 21 – 23. Trio Capital Fraud is discussed in detail in Part V.

¹⁰⁵ *Ibid* 26 -57.

¹⁰⁶ It has been argued that these provisions of the *ASIC Act* specifically apply to 'financial services' and do not apply to conduct in relation to 'financial products. However, such arguments should be treated with caution as the definition of a 'financial services includes, the provision of financial product advice and dealing in a financial product: *Company and Securities Law* [16-260] (CCH, online service).

¹⁰⁷ This provision does not apply where conduct contravenes s 670A (misleading or deceptive takeover documents), s 728 (misleading or deceptive fundraising document), s 953A (providing a defective document or statement) and s 1022A (providing a defective disclosure document or statement) of the *Corporations Act*; *Company and Securities Law* [16-260] (CCH, online service).

- section 12DB prohibits a person from making certain false or misleading representations in connection with the supply or possible supply of financial services
- section 12DF prohibits a person from engaging in conduct that is liable to mislead the public regarding the nature, characteristics, suitability for purpose or quantity of a financial service.

Breaches of these provision are punishable by fines. Where the entities are structured as a company, the directors and officers may also be liable,¹⁰⁸ and the directors may be considered to have breached their own directors' duties.¹⁰⁹

There is a clear overlap between the provisions of the *Corporations Act* and *ASIC Act*. In practice, the provisions of the *Corporations Act* will be argued as alternatives, or in addition to, those of the *ASIC Act*.¹¹⁰

F *International Standards*

1 *United Kingdom*

The Financial Conduct Authority (FCA) is responsible for regulating and overseeing the funds management industry in the UK.¹¹¹ The FCA regulates funds established as collective investment schemes (trusts structures) under the *Financial Services and Markets Act 2000* (FSM Act);¹¹² and open-ended

¹⁰⁸ Section 12GB of the *ASIC Act*.

¹⁰⁹ Michael Pearce, above n 18, 464.

¹¹⁰ For example in *ASIC v Heydon Park Ltd* [2005] FAC 1583, it was alleged that the RE of a MIS (Heydon Park) prepared documents containing false representations and provided these documents to investors. ASIC argued that this conduct breached ss 1041E, 1041F, 1041G of the *Corporations Act* and s 12DA of the *ASIC Act*. ASIC also argued that the some of the directors of the RE had breached their directors' duties and their duties as officers of the RE under the *Corporations Act*. See also *Australian Securities and Investments Commission v Preston* [2005] FCA 1805 where it was alleged that an unlicensed financial adviser (Manito Pty Ltd) had made various misrepresentations and had misappropriated funds. ASIC argued that the financial adviser had breached sections 1041E of the *Corporations Act* and ss 12DA, 12DB and 12CB of the *ASIC Act*. ASIC also alleged that the director of the financial adviser breached his director's duties under the *Corporations Act*. These two cases therefore provide a clear example of the way in which these offences are pleaded and the types of fraudulent conduct that they may apply to.

¹¹¹ Formally the Financial Services Authority, which was split into the FCA and Prudential Regulatory Authority under the *Financial Services Act 2012*.

¹¹² Section 235 of the *FSM Act* defines a collective investment scheme as:

[a]ny arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

investment companies (company structures) under the *Open-Ended Investment Companies Regulations 2001*.¹¹³

(a) *Regulated Activities*

The fund manager, trustee, depository and intermediaries are regulated under the *FSM Act*. The *Act* imposes a general prohibition on regulated activities in the UK, unless conducted by an authorised or exempt person.¹¹⁴ Van Berkel explains that ‘most financial related activities are prohibited’ and ‘[t]he authorisation has to be obtained for each of the prohibited activities separately that are being carried out’.¹¹⁵

Regulated activities include dealing in investments, arranging investment deals, investment advice, administering third-party assets and managing investments.¹¹⁶ Consequently, trustees, fund managers, brokers, dealers, custodians and financial advisers and planners must apply to the FCA for permission to perform these activities.¹¹⁷ Authorisation entails certain ‘threshold conditions’ that must be satisfied by a fund, fund manager or intermediary.¹¹⁸ These conditions cover the corporate structure, the assets held and the suitability of the persons involved in the activity.¹¹⁹ The *FSM Act* is therefore analogous to the AFSL regime under the *Corporations Act*.

Similar to Australia, the UK law creates a clear distinction between retail and sophisticated investors. The promotion of interests in ‘qualified investor schemes’ is an exempt regulated activity,¹²⁰ and fund managers are allowed to promote interests in unregulated funds marketed to high net worth individuals, professional investors or sophisticated investors.

¹¹³ An alternative structure, the contractual scheme, was recently introduced under the *Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013*. The Explanatory Memorandum to the *Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013* explains that the contractual scheme was introduced with a view to providing a transparent structure for collective investments, as collective investment trusts and OEICs are not transparent. The contractual scheme can be structured as a co-ownership scheme, which is not a separate legal entity from its investors or a limited partnership.

¹¹⁴ Section 19 of the *FSM Act*.

¹¹⁵ S. Van Berkel, above n 30, 211. Section 22 of the *FSM Act* also prohibits a person from communicating an invitation or inducement to engage in investment activities, unless they are an authorised person or an authorised person approves the content.

¹¹⁶ Section 22 and sch 2 of the *FSM Act*.

¹¹⁷ Section 40 of the *FSM Act*.

¹¹⁸ *Ibid* s 41.

¹¹⁹ Schedule 6 of the *FSM Act*.

¹²⁰ Financial Conduct Authority, *Collective Investment Schemes Handbook* (2013) COLL 8.1 and *Conduct of Business Sourcebook* (2013) COBS 4.12.

(b) *Fraud and Misconduct*

Misleading statements and practices are prohibited under the *Financial Services Act 2012* (Financial Services Act):

- section 89 prohibits a person from making misleading, false or deceptive statements or forecasts with the intention of inducing a person to do something in relation to an investment;¹²¹ and
- section 90 prohibits a person from knowingly engaging in conduct that creates a false or misleading impression regarding the market in or price or value of any investments for the purpose of inducing a person to acquire, dispose, subscribe for, underwrite an investment or refrain from doing so.

Interestingly, the UK appears to rely more heavily on general fraudulent conduct provisions, not specific to the financial services sector, i.e. the *Theft Act 1968* (Theft Act) and the *Fraud Act 2006* (Fraud Act):

- section 15 of the *Theft Act* prohibits a person from obtaining property that belongs to another by dishonest deception, with the intention of permanently depriving the other of it;
- section 17 of the *Theft Act* prohibits a person from falsifying accounts or records required for accounting purposes and furnishing false, misleading or deceptive information;¹²²
- section 2 of the *Fraud Act* prohibits a person from dishonestly making a false representation with the intention of making a gain for himself or another, or causing a loss to another; and
- section 4 of the *Fraud Act* prohibits a person from dishonestly abusing their position to make a gain for themselves or another person.

For example, the Serious Fraud Office (SFO) (the UK fraud prosecutor) recently commenced proceedings against Magnus Peterson, a director of Weaving Capital (UK) Limited (Weaving), for breaches of the *Theft Act* and *Fraud Act*.¹²³

¹²¹ This applies whether the statements or forecasts are made recklessly or by omission of material facts.

¹²² Where a director or officer of a company has consented to these breaches, they will also be in breach of these offences: s 18 of the *Theft Act*.

¹²³ The Financial Times, *Weaving Capital found Pleds Not Guilty to 16 Charges* (6 February 2014) <<http://www.ft.com/cms/s/0/3a9a2e20-8e8c-11e3-b6f1-00144feab7de.html#axzz2zsbbebRu3>>. The Weaving case is discussed in Part V.

The directors of Weaving: inflated the value of the assets of the Weaving Macro Fixed Income Fund (WMFI Fund); conducted a number of sham transactions through the investment fund manager Weaving; and misappropriated property of the WMFI Fund. Currently, the specific charges raised are unclear; however, the provisions of the statutes discussed above could apply.

2 *United States*

The Securities and Exchange Commission (SEC) supervises the funds management industry and regulates key participants – funds, brokers and dealers, and investment advisers.¹²⁴ The *Securities Act of 1933* (Securities Act), *Securities Exchange Act of 1934* (Exchange Act), *Investment Advisers Act of 1940* (Advisers Act) and *Investment Company Act of 1940* (Company Act) are the main statutes that regulate the operation of the fund management industry in the US.¹²⁵

(a) *Regulated Activities*

The *Securities Act* regulates the offer and sale of securities and prohibits the sale of securities not registered with the SEC.¹²⁶ The *Act* does not apply to the offer and sale of securities by people who are not issuers, underwriters and dealers.¹²⁷ More importantly, it does not apply to the offer and sale to ‘qualified purchasers,’¹²⁸ small-scale offers¹²⁹ and private placement offers.¹³⁰ Unlike in Australia, the *Securities Act* requires the securities themselves to be registered, not the fund. However, the ultimate result is arguably the same, as registration imposes disclosure obligations regarding the securities and the issuer (fund).¹³¹

¹²⁴ Lydie Pierre-Louis, above n 15, 38.

¹²⁵ HerbertSmith LLP, (2011) 1.1 *SEC Adopts Final Rules to the Investment Advisers Act of 1940 Implementing Provisions of the Dodd Frank Act* <http://www.herbertsmithfreehills.com>.

¹²⁶ Section 5 of the *Securities Act*. The definition of ‘security’ applies to a wide range of financial products, including a note, stock, bond, certificate of interest or participation in any profit sharing agreement, investment contract or any interest or instrument commonly known as a security: s 2(1) of the *Securities Act*.

¹²⁷ Section 4(1) of the *Securities Act*.

¹²⁸ *Ibid* s 18(b)(3).

¹²⁹ Section 4(6) of the *Securities Act*. A small-scale offering is one where the amount raised from the sale of the securities in a 12 month period does not exceed \$1 million and does not exceed a specified level of the net worth of the investor.

¹³⁰ Sections 4(2) of the *Securities Act*. A private offer is one that is not made to the general public and is instead made privately, usually to wealthy accredited or institutional investors who are able to protect their own interests: Lydie Pierre-Louis, above n 15, 47.

¹³¹ S. Van Berkel, above n 30, 208.

The *Company Act* requires investment companies to register with the SEC.¹³² Funds are likely to be considered investment companies requiring registration, regardless of the structure chosen.¹³³ The *Company Act* does not apply to funds beneficially owned by less than 100 investors and do not make a public offering of their securities,¹³⁴ or those funds that are owned by ‘qualified purchasers’ and do not make public offerings.¹³⁵ Registered investment companies must meet disclosure requirements, and comply with the regulations regarding capital structure,¹³⁶ payment of dividends¹³⁷ and board structure.¹³⁸

The *Exchange Act* and *Advisers Act* regulate fund management. These two statutes taken together are analogous to the AFSL regime under the Australian *Corporations Act*. The *Exchange Act* requires brokers and dealers to be registered.¹³⁹ Registration incurs a number of disclosure and financial reporting obligations. Importantly, the *Exchange Act* does not apply to brokers and dealers who trade on their own accounts.¹⁴⁰

The *Advisers Act* regulates the conduct of investment advisers, and prohibits an adviser from operating without SEC registration.¹⁴¹ Registration places record keeping, reporting and disclosure obligations on the investment adviser and the funds it advises.¹⁴² The *Act* does not apply to an investment company that is a private fund adviser¹⁴³ or a foreign private adviser.¹⁴⁴

¹³² Section 8 of the *Company Act*.

¹³³ An investment company is defined as any ‘issuer that holds itself out as being engaged primarily in ... the business of investing, reinvesting or trading in securities’: s 3(1)(a) of the *Company Act*. Investment companies are further divided into different categories such as management companies and unit investment trusts: s 4 of the *Company Act*.

¹³⁴ Section 3(c)(1) of the *Company Act*.

¹³⁵ *Ibid* s 3(c)(7)(A).

¹³⁶ *Ibid* s 18.

¹³⁷ *Ibid* s 19.

¹³⁸ S. Van Berkel, above n 30, 209.

¹³⁹ They can be registered with the national securities exchange or registered securities association: s 15 of the *Securities Act*.

¹⁴⁰ Section 3(a)(5) of the *Exchange Act*.

¹⁴¹ Section 203 of the *Advisers Act*. An investment adviser is defined as a person who engages in the business of advising others as to the value of securities or the advisability of investing in certain securities: s 202(11) of the *Advisers Act*.

¹⁴² Section 204 of the *Advisers Act*.

¹⁴³ *Ibid* s 203(m). The private adviser exemption was repealed under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* in July 2011. Under the previous provisions, an adviser who had less than 15 clients over the preceding month and did not offer advice to the general public was exempt from the *Advisers Act*: see generally, HerbertSmith LLP, above n 126. The private fund adviser exemption now applies to an investment adviser whose principle place of business is outside the US, advises private funds only and has less than US\$150 million. Such an adviser is exempt from the registration requirement; however it is still required to comply with certain reporting obligations.

¹⁴⁴ Section 203(b)(3) of the *Advisers Act*. A foreign private adviser is an adviser who has no place of business in the US, has fewer than 15 clients in private funds advised by the adviser, has aggregate funds under management from its US investors of US\$25 million and does not hold itself out as an adviser to the US public or advise registered investment companies or registered business development

As in Australia, there is a distinction between retail and sophisticated investors. Funds and intermediaries servicing retail investors are subject to more stringent regulation. Further, funds, managers and intermediaries are able to structure themselves so that the four main statutes do not apply (mainly by restricting access to sophisticated investors).¹⁴⁵ This can be contrasted with the position in Australia, where most funds will either be directly or indirectly regulated by ASIC under the AFSL regime, even if they are not required to register as a MIS under the *Corporations Act*.¹⁴⁶

(b) Fraudulent Conduct

The *Securities Act*, *Exchange Act* and *Advisers Act* all prohibit fraudulent conduct, regardless of whether SEC registration is required:

- section 17 of the *Securities Act* prohibits a person from employing a device or scheme to defraud; obtaining property due to untrue statements or material omissions; or operating a business that operates as a fraud or deceit on purchasers;¹⁴⁷
- section 10(b) of the *Exchange Act* prohibits the use of any manipulative or deceptive device or contrivance in connection with the purchase or sale of securities in contravention of rules and regulations prescribed by the SEC; and
- section 206 of the *Advisers Act* prohibits an investment adviser from employing a device or scheme to defraud clients; engaging in any conduct that operates as a fraud or deceit on the client; or engaging in conduct that is fraudulent, deceptive or manipulative.¹⁴⁸

The Bernie Madoff case provides a useful example of how these provisions actually operate.¹⁴⁹ The SEC alleged that Madoff and his company, BMIS, committed fraud through the adviser activities of BMIS. The fund was not registered with the SEC; however, BMIS was registered as a broker dealer and financial adviser under the *Advisers Act*. Madoff and BMIS were charged with breaches of section 206 of the *Advisers Act*, section 17(a) of the *Securities Act* and

companies: s 202(a)(30) of the *Advisers Act*; DLA Piper, *Foreign Private Advisers Under Dodd-Frank* (January 2012) <<http://www.dlapiper.com>>.

¹⁴⁵ Since the *Dodd-Frank Wall Street Reform and Consumer Protection Act* *Dodd-Frank Act* took effect in July 2011, a number of these loopholes were either closed or tightened.

¹⁴⁶ Robert Bianchi and Michael Drew, above n 48, 12.

¹⁴⁷ Section 17 of the *Securities Act*.

¹⁴⁸ Section 206 of the *Advisers Act*.

¹⁴⁹ See further discussion in Part V.

section 10(b) of the *Exchange Act*.¹⁵⁰ Importantly, these offences applied even though the fund itself was not registered with the SEC.

V EXAMPLES OF FRAUD IN AUSTRALIA AND OVERSEAS

This section examines a number of fraud cases that have occurred recently. They highlight how the fraud occurred, who masterminded it and more importantly, how the fraud went undetected for a significant period of time. Though failure to identify the fraud may indicate poor oversight by authorities, it is also a confluence of lax compliance practices, determined and brazen fund managers, and investors who turned a blind eye to overt examples of fraudulent practices.

A *Australia: Trio Capital*

Perhaps the most infamous instance of deception that also carries the insalubrious title of being ‘the largest superannuation fraud in Australian history’¹⁵¹ is the case of Trio Capital. In June 2011, the Parliamentary Joint Committee on Corporations and Financial Services (PJC) mounted a parliamentary enquiry into the failings, which led to and otherwise contributed to the fraud perpetuated by Trio Capital. This included an examination of what led to \$176 million of investor funds being siphoned from two managed funds – Astarra Strategic Fund (ASF) and ARP Growth Fund (ARP).

ASF and ARP were two of a large number of funds managed by Trio Capital. ASF was an Australian based hedge fund, whilst ARP was structured as a registered managed investment scheme that owned a contract held by a company in the British Virgin Islands. The ASF and ARP also invested in offshore funds located in the British Virgin Islands, Cayman Island and St Lucia. The reason this crime is known as ‘superannuation’ fraud is primarily because the funds misappropriated from ASF and ARP were invested by superannuation entities that were also managed by Trio Capital.

Much of the alarm around the Trio Capital fraud is how such activities could go undetected. Where an opportunistic crime such as fraud is involved, the failure is not only in the investment decision made by the victim, but also highlights the flaws in the risk management and governance framework employed by the ‘gatekeepers’. Superannuation trustees are highly regulated entities primed to

¹⁵⁰ *Securities and Exchange Commission v Bernie L Madoff, Bernard L Madoff Investments Securities LLC*, (SDNY Civ 08 CV 10791, 2008): see, <<http://caselaw.findlaw.com/us-2nd-circuit/1654662.html#sthash.rapn5kh6.dpuf>>.

¹⁵¹ Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the Collapse of Trio Capital* (May 2012) xvii <<http://www.aph.gov.au>>.

safeguard against the loss of investment funds from unscrupulous operators through heavy monitoring and oversight obligations.

The first safeguard was the RSE licence held by Trio Capital as trustee for a number of its superannuation funds. The second safeguard was in the form of an AFSL issued by ASIC. In contrast to an RSE licence, an AFS licence has a greater focus on consumer protection and market integrity. Both licences impose on the holder a number of obligations – thus requiring entities to ‘self-regulate’ their conduct.

A notable obligation is the requirement for entities offering custodial services to hold an AFS licence which requires the custodian to meet certain liquidity requirements.¹⁵² From a policy perspective, this acts as an extra measure, protecting beneficiaries’ interests from the misuse of trust property. Given the nature of the relationship between the trustee and the custodian, the custodian acts as a ‘gatekeeper’ as it is responsible for the flow of assets within the trust structure. In the case of Trio Capital, ANZ Custodian Services and later, National Australia Trustees Ltd acted as custodians of the investor assets. Despite this added layer of protection, the role of the custodian did not extend to verifying underlying assets or in effect querying instructions given to them by the trustee, especially when those funds were moving overseas.

Whilst investing the funds offshore was a ploy to avoid detection and ultimately prevent recovery of the stolen funds, the Trio Capital’s fraud was successful by exploiting the vulnerabilities of the regulatory framework designed to protect against such misconduct. Investments made offshore can sometimes be used for nefarious purposes, for example, by investing funds in complex investment vehicles operating with less stringent guidelines. Once funds leave Australia, bodies such as APRA and ASIC are hindered in their ability to trace the funds and are at the mercy of foreign regulators. Almost as a ‘comedy of errors’, the Trio Capital fraud occurred as a result of the following failings:

- In the evidence given to the PJC enquiry, APRA submitted that it was a prudential regulator with an oversight role, which did not extend to investigating fraud where no complaint had been made or valuing underlying assets. This was the role of the fund auditors.
- The fund auditors routinely valued the underlying assets of the funds and found no deficiencies. They argued they had no way of knowing that the documentation provided to them by the funds’ administrators were fraudulent.

¹⁵² Clayton Utz, *Revised AFSL Financial Requirements: Making Custody Safer* (7 December 2012) <<http://www.claytonutz.com/publications/news>>.

- It was submitted that ASIC’s powers are designed to not be so pervasive as to limit the efficiency of the market. In so doing, ASIC is only an oversight and enforcement body that can only ‘arrive “at the scene of the accident” ... to see who caused it,’ with otherwise limited power to ‘act ahead of time.’¹⁵³
- The compliance framework imposed on entities like Trio Capital was found to be inadequate and created an abundance of ‘red-tape’ that can be easily circumvented if there is no real intention to comply.

Despite Trio Capital being subject to a myriad of regulatory obligations as a dual-regulated entity, neither APRA nor ASIC knew the extent of the fraud until concerns were raised by a whistle blower. Prior to taking formal action to locate the missing funds, APRA acknowledged that for a number of years it had concerns over the veracity of the reports submitted by Trio Capital. This resulted in a protracted investigation that drew the regulator no closer to unearthing the fraud. Even after its concerns were not abated, APRA failed to alert ASIC to the discrepancies in the operations of the funds being managed by Trio Capital. This lack of communication between the two regulatory bodies has been the subject of much criticism by the PJC.

Despite the extent of the damage caused by this fraud, the perpetrators have largely escaped severe punishment. Only Shawn Richards, a former director of Trio Capital has been sentenced to a jail term of 3 years and 9 months;¹⁵⁴ whilst Tony Maher, a former investment manager pleaded guilty to 20 criminal charges and is awaiting sentencing. He faces a maximum penalty of five years imprisonment and/or a fine of \$110 000 – the fine being significantly less than the actual loss sustained by the victims. The remaining directors of Trio Capital have escaped a jail term, by giving enforceable undertakings to not be involved in the financial services industry or manage a company for between two to 15 years.¹⁵⁵

B *United States: Bernie Madoff Investment Securities (BMIS)*

¹⁵³ Tony D’Aloisio, ‘Regulatory Issues Arising from the Financial Crisis for ASIC and for Market Participants’ (Speech delivered at the Securities & Derivatives Industry Association, Sydney, 29 May 2009) <<http://www.asic.gov.au/asic/asic.nsf/byheadline/Speeches+portal>>.

¹⁵⁴ *Ibid*, 5.

¹⁵⁵ Australian Securities Investment Commission, Enforceable Undertaking pursuant to section 93AA of the *ASIC Act* given by David O’Bryen document number 02744362 (24 August 2011) <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/027444362.pdf/\\$file/027444362.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/027444362.pdf/$file/027444362.pdf)>. The remaining directors of the RE, Natasha Beck, Keith Finkelde, David Andrews and Rex Phillpott also gave enforceable undertakings: ASIC Media Release 11-182 MR *Remaining Trio former directors excluded from financial services industry for four years*, 24 August 2011; ASIC Media Release 11-133MR, *Former directors of Trio Capital prevented from working in the financial services industry*, 4 July 2011.

Regarded as ‘the con of the century’¹⁵⁶ and an ‘extraordinary evil’,¹⁵⁷ the Bernie Madoff case was a brazen swindle that resulted in investors losing up to US\$65 billion. This case caught regulators and the world so unaware, that President-elect Barack Obama publicly confessed that, ‘we fell asleep at the wheel.’¹⁵⁸ Madoff operated a Ponzi scheme – which, in its basic form, is a pyramid scheme where redemptions are paid out from the deposits of investors, instead of the underlying investment returns. Ironically if not for the GFC, the Madoff fraud may still be on going today, with the regulators still blind to the damage being perpetrated.

Bernie Madoff’s success was partly based on a very carefully structured system of lies, which was able to remain concealed through the development of an investment structure that was largely impregnable to impartial oversight by an independent body. Madoff used his reputation to coax investors to invest their life savings, by making attractive promises on his ability to generate exceptional returns, whilst simultaneously duping the SEC. With the wisdom of hindsight, commentators note that despite the amount of money involved and the success of the deception, the mechanics of the fraud were in fact ‘not impressive’¹⁵⁹ and, if robust due diligence enquiries had been made at the time or even rudimentary mathematical calculations conducted on the investment returns marketed, it would have highlighted the improbability of Madoff’s claims. Madoff was able to sustain this myth by shunning any real scrutiny of his actions. He used a structure where his firm, BMIS, acted not only as a broker and investment manager, but also as the custodian.

At one end, Madoff attracted high net worth clients and large organisations, whilst at the other end, large financial institutions invested in BMIS either through a feeder fund or hedge fund. In this way, the hedge fund was intentionally structured to avoid the requirement to register with the SEC. The real conflict of interest however lay in the fact that these institutions also engaged BMIS to act as a broker and investment manager and custodian over the funds invested, thus resulting in the firm taking on the dual role of both operations and oversight. On its face, this structure was not illegal as SEC regulations at the time, permitted asset management firms to act as custodians.¹⁶⁰ However, in considering the

¹⁵⁶ Luis Aguilar, *Strengthening Oversight of Broker-Dealers by Instituting a Framework to Prevent Another Madoff* (31 July 2013) U.S. Securities and Exchange Commission <<http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370539742041>>.

¹⁵⁷ Janet Morrissey, *The Penalty for 'Extraordinary Evil': Madoff Gets 150 Years* (29 June 2009) TIME <<http://content.time.com/time/business/article>>.

¹⁵⁸ Pierre Clauss et al, *Risk Management Lessons from Madoff Fraud* (2 March 2009) Munich Personal RePEc Archive <http://www.mpra.ub.uni-muenchen.de/36754/1/MPRA_paper_36754.pdf>.

¹⁵⁹ Ibid 4.

¹⁶⁰ Section 17(f) of the *Investment Advisers Act of 1940*.

entire arrangement, it is clear how it was such a flawed model.¹⁶¹ Since the Madoff scandal, the SEC has adopted sweeping amendments to the regulations governing custody practices.

As is the case with most instances of fraud, it came to light, it was not the proactive investigations of the regulator that eventually uncovered the fraud, but the persistence of a whistle blower who was repeatedly ignored by the SEC. Similar to the situation in Trio Capital, the lack of communication between various SEC offices and the inexperience of the staff led to an inordinate period of time before the fraud was uncovered. As the GFC led to jittery investors seeking to make redemption requests on their investments, Madoff struggled to meet these demands, given the flow of funds into his Ponzi scheme was also starting to dwindle. Consequently as investor complaints mounted, the SEC was prompted to turn to the claims made by a whistle blower. The whistle blower was concerned that mathematically, the high returns gained from Madoff's investment strategy could not be justified. The whistle blower unsuccessfully tried to convince the SEC of the fraud being committed by Madoff for a number of years, but was repeatedly ignored. In one instance, it was reported that a SEC member failed to take his concerns seriously on the grounds he was not employed by Madoff and therefore could not know the inside workings of the funds.¹⁶²

Unlike Trio Capital (though the quantity of loss was comparatively far greater in this case) Madoff was sentenced to an imprisonment term of 150 years and restitution in the vicinity of US\$7.2 billion. He was found guilty of 11 felony counts including securities fraud, perjury, investment advisor fraud, mail fraud, wire fraud, three counts of money laundering, false filings to the SEC and theft from an employee benefit plan.¹⁶³ Other participants in the fraud also received jail terms.

C *United Kingdom: Weaving Capital (UK) Limited*

Weaving, the investment manager for the Cayman Island based WMFI Fund, is the company behind the largest fraud case yet witnessed in the UK.¹⁶⁴ After its collapse in 2009, it was discovered that Weaving's directors had defrauded

¹⁶¹ See, John Reeves, *Why the Bernie Madoff Case is so Dangerous for JPMorgan Chase* (14 December 2013) <<http://www.fool.com/investing/general>>.

¹⁶² Harry Markopolos, *No One Would Listen: A True Financial Thriller* (John Wiley & Sons, 2010).

¹⁶³ As noted in Part IV above, this included breaches of the *Advisers Act*, the *Securities Act* and the *Exchange Act*: see, *Securities and Exchange Commission v Bernie L Madoff, Bernard L Madoff Investments Securities LLC*, (SDNY Civ 08 CV 10791, 2008).

¹⁶⁴ Lavan Partners, *The Weaving Case: A Fine Line between Negligence and Fraud* (13 July 2012) <<http://www.lavenpartners.com/2012/07/the-weaving-case-a-fine-line-negligence-fraud/>>.

US\$600 million from investors of. As with the Madoff case, Weaving's downfall is closely linked to the actions of founder Magnus Peterson.

In 1998, Weaving Capital Fund Limited (WCF) was incorporated in the British Virgin Islands, its investors being Peterson, his wife and another investor. WCF's aim was to trade aggressively in global interest rate markets. However, the company soon suffered heavy losses and ceased to actively trade. It was subsequently transformed into a private investment vehicle for Peterson and his wife. In 2000, Peterson established another company in the Bahamas, also called Weaving Capital Fund Limited (WCF Bahamas). WCF Bahamas was structured as a hedge fund managed and also suffered heavy losses in 2001. Shortly afterwards, WMFI Fund was established. The string of investment entities established by Peterson was not so much seen as a need to establish a complex investment structure, but rather a desperate undertaking by Peterson to mend his broken ego after each failed investment attempt.¹⁶⁵

Unlike WCF and WCF Bahamas, WMFI Fund was established as a low risk hedge fund and marketed as providing secure returns. Upon listing on the Irish Stock Exchange in 2003, financial institutions, superannuation funds, charities and high net worth clients flocked to invest in WMFI Fund. Within just over two weeks, WMFI lost 19.3 per cent of its portfolio in exchange trading. To cover what was perceived as a personal failing, Peterson procured the WMFI Fund to enter into interest rate swap agreements with WCF via over-the-counter (OTC) options,¹⁶⁶ resulting in the 19.3 per cent loss appearing as a 3.2 per cent profit. Eventually, the WMFI Fund's exposure to the transactions increased from 40 per cent in 2004 to 94 per cent of the fund's assets in 2009.¹⁶⁷

Though Peterson vehemently maintains that the swap agreements were legitimate transactions, there are worrying signs pointing to a more sinister motive, particularly:¹⁶⁸

- Poor governance practices – most of Weaving's directors were found to be neither independent nor fit for their role. Speculation is that this was to

¹⁶⁵ See generally, Richard Ruffer, 'Fiduciary Duties' (2011) 10 *International Custody & Fund Administration*, 38-47.

¹⁶⁶ OTC options (or dealer options) are traded between a private buyer and seller and are therefore not listed on a stock exchange. The type of options generally traded includes, interest rate options, currency cross rate options or swap options. OTC options belong to the derivatives class of financial products.

¹⁶⁷ See generally, Mohd-Sulaiman and Aiman Nariman, 'Financial Reporting Failures, Board's Competency and Effectiveness' (2013) 10(2) *International Journal of Disclosure and Governance*, 155.

¹⁶⁸ *Weaving Capital (UK) Ltd (In Liquidation) v ULF Magnus Michael Peterson & 9 Ors* [2012] EWHC 1480 (Ch).

ensure that Peterson was unhindered in his fraudulent conduct, knowing that the board's shortcomings would result in little scrutiny.

- Misleading public documents – the offer and marketing documents for WMFI Fund showed glaring inaccuracies and omissions on important matters, such as its policy on OTC transactions, investments and risk management practices.
- Inconsistent valuations – the fund's net asset value was deliberately manipulated to demonstrate low volatility.
- Deficient office support – back office support for processing trades and maintaining accurate records, was described by the court as 'amateurish and irregular,' being borne out of a culture of non-compliance perpetuated by Peterson.
- Operating outside investment guidelines – Peterson engaged in an investment strategy inconsistent with the fund's investment concentration restrictions, by investing in swaps with a related entity. Further, given this was a related party transaction, the court found no discernable risk mitigation strategies in place nor real evidence of arm's length conduct between the entities.

Given its cross-jurisdictional nature, the matter, has undergone consideration in both the UK and Cayman Islands. The Grand Court of the Cayman Islands awarded damages of US\$111 million against two directors of Weaving. The UK High Court awarded damages of US\$450 million against Weaving's directors. The SFO has also charged Peterson with six criminal offences relating to fraudulent conduct, forgery and false accounting.

The fraud was unearthed when WMFI Fund went into liquidation after discovery that its value had been 'manipulated' to conceal its true dire state from investors. During investigation, the liquidators discovered such serious instances of deception that they brought proceedings against the directors, despite the SFO having closed their investigation without any prosecutions. What raised the public ire is that, despite warnings, the SFO failed to prosecute the perpetrators. SFO had made the decision to abandon its investigation into the Fund, on its opinion that there was little prospect of convicting the directors. It was only after the Cayman Islands decision that the SFO brought criminal charges against Peterson. From a regulatory perspective, the question remains, could the SFO or the Financial Services Authority (FSA), the then peak regulatory financial body, have prevented the fraud. Like ASIC, the FSA (now FCA) takes an oversight role which does not

include confirming the accuracy of statements available in the public domain, vetting business models of investment entities or checking whether a fund's asset value has been manipulated. This responsibility is largely placed on the auditors, who have also been accused by investors of negligence.

D *Canada: Portus Alternative Asset Management Inc*

Portus Alternative Asset Management Inc (Portus) has been described as a 'major blot' on the Canadian hedge fund industry,¹⁶⁹ with the fraud having all the hallmarks of brazen swindle involving diamonds, fugitives and missing millions. Portus was a hedge fund that quickly gained popularity among both retail and large institutional investors, amassing almost C\$730 million in assets at the height of its success. It has since been uncovered that most of these investment funds were funnelled into the personal accounts of the owners of the business, with millions still unaccounted.¹⁷⁰

The success of the fund was largely due to an aggressive marketing strategy promising advisors lucrative fees and an investment plan privately referred to as their 'secret sauce'.¹⁷¹ Internal documents indicate the sales strategy was so bold that staff was encouraged to sell the product to the financial planning fraternity with a promise of absolute returns. The focus on the financial planners was part of the sales strategy of the fund, which shied away from directly marketing to retail investors and instead luring planners with healthy referral fees to steer customers towards their hedge fund. Portus allegedly paid advisers up to 5 per cent of the assets referred, plus an additional quarter of an 18 per cent annual performance fee. Hence, as more money funnelled into the fund, the financial planners were rewarded with a higher percentage return. The commissions, however, also

¹⁶⁹ Richard Wilson, 'Hedge Funds in Canada – Canadian Hedge Fund Guide' on Richard Wilson, *Hedge Fund Blogger* (2008) <<http://www.richard-wilson.blogspot.com.au>>.

¹⁷⁰ See generally, Canadian Foundation for Advancement of Investor Rights, *A Decade of Financial Scandals* (February 2011) <<http://www.faircanada.ca/top-news/fair-canada-releases-report-on-financial-scandals/>>.

¹⁷¹ Sinclair Stewart and Paul Waldie, *Portus's Secret Sauce* (15 February 2005) InvestorVoice.ca <<http://www.investorvoice.ca/Scandals/Portus/Portus21.htm>>.

flowed the other way, with the ‘fund of funds’ managers being enticed with a 1 per cent to 2 per cent annual fee, including a performance fee of 20 per cent.¹⁷²

The fund came to existence in 2003 and was initially known as the Paradigm Asset Management Inc. It was famously known to operate ‘Paradigm boot camps’ out of military compounds, where sales staff was put through rigorous training to instruct them on how to market the product to advisers. Sales grew not only as a result of this sales strategy but also as a result of Paradigm’s close relationship with hedge fund guru James Park of Paradigm Global Advisers LLC. Park’s name and company lent credibility to an otherwise unknown fund, where investors were led to believe that Park played a critical role. This was the first in a long line of misleading statements made to investors, as it was later uncovered that apart from a limited consultancy arrangement, Park was not associated with the company. Further, despite the similarity in the names of the two companies, there was no ownership link between the entities. However, once the tenuous relationship terminated in 2004, the company changed its name to Portus, but continued its aggressive sales strategy. This strategy was highly successful and in less than two years, Portus had approximately 26,000 investors. The fund started to wane in the market when a number of industry professionals questioned the fund’s success given its highly secretive investment strategy.

The masterminds behind the fraud, was primarily its co-founders Boaz Manor and Michael Mendelson. After the firm’s collapse, Manor escaped to Israel amid allegations that he siphoned millions of dollars of investor funds from Portus. Liquidators claim that Manor attempted to transfer approximately US\$8.6 million in investor funds from Swiss bank accounts to accounts held in Hong Kong. In addition, approximately US\$11.6 million of investor funds were used to purchase precious stones, including diamonds.¹⁷³

The regulator in this case, however, was swift and decisive in dealing with the fund. The Ontario Securities Commission (OSC) acted almost immediately to place a stop order on the fund to prevent it from opening new accounts or accepting new investments, after serious concerns were raised with the regulator. Not long after, KPMG were appointed to forensically examine the financial accounts of the fund, where it discovered the nature of the fraud and has led to a global hunt for the missing millions and diamonds. Though it is the actions of the co-founders that led to Portus’ demise, some commentators have pointed to early

¹⁷² *Ontario (Securities Commission) v. Portus Alternative Asset Management Inc* [2006] 19 CBR (5th) 17 (Ont Superior Court of Justice) 47 – 50: see,

<http://www.osc.gov.on.ca/en/Proceedings_rad_20121129_portus-mendelson2.htm>.

¹⁷³ Canadian Foundation for Advancement of Investor Rights, above n 171.

warning signs, such as Parks' tenuous involvement and the sales driven environment that should have alerted investors.¹⁷⁴

Despite the extent of funds misappropriated, the co-founders have largely escaped hefty penalties. Manor and Mendelson were charged with fraud, money laundering and possession of property of crime offences. Manor was also charged with obstruction of justice for his actions in attempting to avoid prosecution by moving to Israel. Mendelson received a two-year jail term, whilst Manor, the key instigator of this crime, received a four-year jail term for the fraud (and an additional two years for disobeying a court order).

VI POLICY REFORM CONSIDERATIONS

This section examines some key policy reform areas. It seeks to identify 'gaps' in the current legislative framework and using the examples of fraud cases examined above identify other preventative measures that Australia could adopt. Though it is with hindsight that these policy considerations are being examined, it is nonetheless important to continually examine ways to make sure that the regulatory framework in place is robust, flexible and where possible, impenetrable.

As demonstrated in the examples above, fraud is a burgeoning problem that has the potential to undermine consumer confidence and the stability of the market. Notably, most of these cases of fraud were uncovered during a time of extreme market instability. An overwhelming focus on profits becomes untenable when the market contracts and investments start to dwindle, thus placing greater emphasis on the skill and expertise of the fund's operators and the resilience of the fund's investment strategy in surviving such uncertainty. It is however not only market turbulence, which can undermine consumer confidence, but also cases of misconduct and stories of investors unwittingly caught in the fray. It is at such times and with the wisdom of hindsight, the regulatory framework is truly tested. In this section we note some policy reform considerations in light of the fraud cases considered.

A Penalties

¹⁷⁴ Bruce Lively, *Where are the Portus Diamonds?* The Globe and Mail (25 October 2012) <<http://www.theglobeandmail.com>>.

White-collar crime does not garner the same level of empathy as other criminal acts, but they nonetheless have the potential to cause significant harm. In the Trio Capital case, investors lost their life savings and retirement funds because of the fraudulent acts of a few who reaped significant benefits. Those responsible for the fraud escaped severe punishment, as the penalty imposed on the directors was not commensurate with the damage caused. Conversely, in the case of Bernie Madoff, the US court imposed a jail term of 150 years for the crimes he committed. Whilst the quantum of loss and duration of the fraud far exceed those of Trio Capital, Weaving and Portus – they nonetheless provide some guidance on the level of punishment that should be dispensed to those who engage in such conduct. In sentencing Bernie Madoff, the court concentrated on each instance of deception rather than the Ponzi-scheme itself. For example, he was found guilty of criminal counts relating to theft, various types of fraud and false information.¹⁷⁵ These charges culminated in a hefty penalty. Conversely because of Australia's current penalty system for corporate crimes, most of the directors are only facing an administrative banning. Such actions ultimately fail to restore confidence in the industry or act as a deterrent. There is therefore little disincentive for those intent on deceit to change their behaviour.

B *Offshore Investments*

As noted above, one common method used to avoid detection is by investing funds in complex structures overseas. Though disclosure documents may indicate that funds will be invested overseas, they fail to detail the nature of the investment, the structure of the investment vehicle, the particular jurisdictional risks of investing in the particular country and what measures (if any) are taken to supplement compliance processes. Ordinarily, disclosure documents that provide some level of detail about the nature of the investment do not adequately describe the investment strategy because it is too complex. Despite this triviality, investors should be making fully informed investment decisions. Though this does not prevent fraud from occurring, it will nonetheless highlight any unusual features or 'red flags' that should alert investors and regulators.

C *Gatekeepers*

Gatekeepers such as custodians and auditors have equally been implicated in some of the cases of fraud noted above. Though these parties have not been complicit in the fraud, their lack of oversight has resulted in many instances of fraud going undetected for years. Independence and robust investigations are necessary tools to ensure the integrity of the compliance role imposed on auditors and custodians.

¹⁷⁵ Janet Morrissey, *The Penalty for 'Extraordinary Evil': Madoff Gets 150 Years* (29 June 2009) TIME <<http://content.time.com/time/business/article>>.

In particular, auditors need to have a level of independence and their enquiries need to extend beyond relying on the information provided to them by the fund operators, or otherwise face being held accountable for the fraud. For example, investments made overseas and the assets purported to be held by the fund need to be vigorously examined. In addition, custodians should ideally take a greater oversight role. As a custodian carries out the instructions provided to them by the fund's operators, they should simultaneously be conducting basic investigations to highlight any unusual commercial transactions. Unfortunately from a commercial viewpoint this may not be practical. Studies show that custodial services are expensive and there are few custodians that operate in the Australian market.¹⁷⁶ Given the nature of their operations and their risk exposure, custodians are highly resistant to taking on a monitoring obligation as this exposes them to litigation. Namely, if the RE of a managed fund collapses, angry investors are likely to turn their sights to alternative means for recourse such as the custodians.¹⁷⁷

Arguably however, Australia has one of the most robust custodial arrangements in the world. Unlike the United States, custodians are required to hold a high value of liquid assets to support their operations. Since the Bernie Madoff case, the United States have significantly changed its policy on custodians, but it still remains starkly behind the policy setting of other countries like Australia.

D *Collaboration between Industry Professionals and Regulators*

One of the key criticisms facing regulators during fraud investigations is the lack of immediate response from the proper authorities. In particular, countries such as Australia, the United Kingdom and the United States are grappling with this issue in the face of extreme condemnation by investors and government oversight bodies. Whether the solution is a policy change or an increase in the power of the regulators, the more palatable option appears to be a need to be more aligned to industry professionals.

The regulatory framework of countries, such as Australia, is drafted in terms that a regulator is only able to assess the damage after the misconduct has come to light. Therefore, there is little opportunity to act more proactively; but the public favours this approach. For example, at the height of a booming market with investments reaching record levels, an investigation by a regulator into a high-performing entity with a view to stopping its operations, is more likely to gain investor anger

¹⁷⁶ Grant Moodie and Ian Ramsay, *Managed Investment Schemes: An Industry Report* (2003) Centre for Corporate Law and Securities Regulation, University of Melbourne <<http://www.law.unimelb.edu.au/files/dmfile/ManagedInvestments2.pdf>>.

¹⁷⁷ Tehani Goonetilleke, 'Obligations and Liabilities of the Key Players in Managed Investment Schemes' (2011) 29 *Company and Securities Law Journal* 419.

than acceptance. In a free market economy, there is always a contention between under-regulation and over-regulation. As economies like Australia favour a minimal regulatory model, there is therefore a greater burden on the industry to self-regulate its conduct. With this in mind, complaints by whistle blowers should be given greater weight than that which has been seen in the fraud cases of Trio Capital, Bernie Madoff, Weaving and Portus.

There is often disengagement between the regulators and the very stakeholders they are seeking to regulate. Regulators should be attuned to concerns raised by industry professionals who have access to a wider network of information and are more aligned to the industry. A more pronounced approach to tap into this knowledge base should be actively pursued. For example, through the establishment of a body comprised of industry participants that sits within the regulator to provide top-level targeted advice.

E The Distinction between Retail and Sophisticated Investors

The regulations in Australia create a clear distinction between retail and sophisticated investors. It is assumed that retail investors require more protection than sophisticated or institutional investors. As a result, funds marketed to retail investors are subject to more stringent regulatory requirements and disclosure obligations.

However, the characterisation of retail and sophisticated investors may need to be re-examined, given the investment by retail funds in other funds (funds of funds). In such cases, retail funds would qualify as sophisticated investors, despite the fact that they are funded by retail investors - thereby indirectly exposing retail investors to greater risks. This is particularly problematic in the context of investments by superannuation funds which may result in the indirect exposure of the public's retirement savings. The simplistic distinction between retail and sophisticated investors may, therefore, need to be re-evaluated.

F Tighter Regulatory Oversight

One approach to limiting fraudulent conduct in the market is to increase the regulator's powers. In this context, this would include requiring the regulator to vet all investment funds and assess the veracity of the claims made. In a report published by a Canadian investor right's organisation, calls were made for the regulator to assign dedicated resources to audit high-risk product offerings.¹⁷⁸ In part, Australia already has a system in place, which aims to provide a balance between over-regulation and free market enterprise. Most key documents are

¹⁷⁸ Canadian Foundation for Advancement of Human Rights, above n 171.

lodged with ASIC and active surveillance activities are routinely carried out in the market, such as ‘mystery shopping’ exercises. This is by far more comprehensive than some of the monitoring undertaken by other regulators. There is an argument that, if ASIC were to undertake a more aggressive monitoring policy then it would have significant implications. Namely an increase in government oversight would stifle market innovation, over-burden the regulator and become a time-consuming exercise for all parties. Despite the ‘comfort’ this approach would bring to investors, it will also have the effect of creating a generation of consumers who negate any responsibility for poor investment choices, with the regulator ultimately held responsible for every failing investment. There needs to be a balance between both sides, but given the leading position Australia’s investment market holds in comparison to other countries, it would not serve to unduly inhibit the growth of this industry due to the actions of a few who are intent on engaging in fraud.

VII CONCLUSION

Part I and Part II of this paper provided general background on funds management and examined some of the key characteristics of investment fraud. Despite the safeguards in place, fraud can occur and be concealed such that it remains uncovered for years. The instances of fraud identified above are merely examples of how a managed fund can be compromised.

Part III provided an overview of the two main corporate structures adopted by Australian funds - trusts and companies. It examined the obligations, duties and liabilities of the main stakeholders: the fund itself; the fund manager; and investors. Fund management intermediaries such as custodians, brokers, dealers, financial advisers and planners provide vital services to the main stakeholders. This section considered the role of these intermediaries. The use of offshore funds and corporate groups to minimise liability was also examined.

Part IV provided an overview of the regulatory authorities and statutes governing funds management in Australia. It examined the regulation of managed investment schemes, superannuation funds and the Australian Financial Services Licence (AFSL) holders under the *Corporations Act 2001* (Cth) and *Superannuation Industry (Supervision) Act 1993* (Cth). The AFSL regime is particularly important, as it provides the overarching regulatory framework for the industry. The section also considered the main provisions prohibiting fraudulent conduct in Australia, and drew on real cases to highlight how the various provisions actually operate. The regulation of funds and prohibition of fraudulent conduct in the United Kingdom and United States was also examined.

In Part V, the four cases highlighted how easily fraud can occur in managed funds. Of concern is that, despite the extent of the damage caused and the loss suffered, punishments imposed on those responsible are disproportionately low, providing little deterrence to future fraudulent activity. As can be seen from these cases, a heightened need exists for legislative change to protect investors.

Changes to the regulatory framework require a balance between growth and innovation, with sound compliance practices and consumer-focused safeguards. This is no easy task and depending on a person's role in the managed funds industry, the importance they place on which end of the spectrum regulatory policy should sit will vary. Further, to protect investors from fraud, those chasing quick returns through investments in extremely high-risk ventures should not escape culpability. Ultimately, the adoption of a suitable regulatory framework need not result in a rigid and inflexible framework, but one which prevents oversight failings and acts as a deterrent.