

Agribusiness MIS Failures: Policy lessons from the Quintis failure

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ABSTRACT

Major failures of Forestry Agribusiness Managed Investment Schemes (MIS) in 2010 created significant losses for retail investors and prompted several subsequent parliamentary inquiries. However, recommendations by those inquiries have not all been implemented, although many have been subsumed into policy changes stemming from the Australian Financial System Inquiry. We argue that reforms proposed and those implemented do not go far enough to resolve inherent problems with the agribusiness MIS model. This paper uses the 2018 failure of Quintis Ltd, a large ASX company and Responsible Entity for 17 such schemes, to assess the remaining gaps in, and suggest needed changes to, tax and regulatory policy for forestry agribusiness activities.

KEYWORDS

Managed Investment Scheme, Responsible Entity, Forestry Agribusiness, Quintis

JEL CODES

G23, G28, G32, Q13

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1. Introduction

Quintis Ltd, one of the 300 largest ASX-listed companies at its peak, was placed into administration in January 2018. It had been a major operator of forestry plantations (specialising in sandalwood) both on its own account and on behalf of wholesale and sophisticated retail investors, as well as retail investors in managed investment schemes (MIS), which it operated in its role as the Responsible Entity (RE). The consequences of its failure bring to attention recognised deficiencies in the tax policy towards, legislative and regulatory arrangements with, and practices of, agribusiness MIS which became apparent previously with significant MIS failures in 2009. In 2016 a Senate Economics References Committee¹ made 24 recommendations for changes to deal with such issues. They have not all been implemented, although a range of broader financial policy changes resulting from the 2014 Australian Financial System Inquiry (AFSI)² encompass some of the Senate committee recommendations. Whether the overall package of changes implemented (and some in progress) are sufficient to overcome recognised problems with the agribusiness MIS model is an important question considered here.

The Quintis failure provides a valuable opportunity to consider how, if at all, the circumstances of this failure differ from earlier ones and the sufficiency of policy reforms affecting Agribusiness MIS. We argue that the Senate Committee recommendations, and the Government response to those,³ fail to address the important structural defects in agribusiness MIS models and use the Quintis failure to illustrate that the deficiencies apparent from earlier failures are still relevant. That analysis also demonstrates that a number of regulatory changes made by ASIC since the earlier failures (discussed later), while warranted, have been insufficient to overcome deficiencies inherent in the forestry MIS business model.

We argue that substantive policy and regulatory changes are warranted, beyond those suggested by the Senate Committee. First, the special tax concessions for agribusiness MIS investments are unwarranted and induce unsophisticated investors to make ill-informed, risky investments – including taking of highly leveraged positions – resulting in inefficient allocation of capital. Second, there appear to be few economic or general tax benefits from operating forestry agribusiness projects via a MIS structure rather than through a company structure. Given the problematic and conflicted nature of the RE model for operation and governance of such opaque projects, we suggest that legislative measures to ensure use of a company structure are merited, and consider whether the Corporate Collective Investment Vehicle (CCIV) model currently (mid 2018) proposed for introduction⁴ would be sufficient to rectify the known problems with Forestry agribusiness MIS. In practice, though, removal of the special tax concessions for agribusiness MIS investments would likely be sufficient to see the demise of this structure.

¹ The Senate Economics References Committee “Agribusiness managed investment schemes Bitter harvest” March 2016, https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/MIS (viewed 26 February 2018)

² Australian Financial System Inquiry “Final Report” November 2014, <http://fsi.gov.au> (accessed 26 June 2018)

³ Australian Government “Australian Government response to the Senate Economics References Committee, Agribusiness Managed Investment Schemes: Bitter Harvest” November 2016.

<https://treasury.gov.au/publication/government-response-to-the-senate-economic-references-committee-inquiry-into-forestry-managed-investment-schemes/> (viewed 26 June 2018).

⁴ Australian Government “Exposure Draft: Treasury Laws Amendment (Corporate Collective Investment Vehicle)” Bill 2018 https://consult.treasury.gov.au/financial-system-division/c2018-t299864/supporting_documents/ccivExposureDraft.pdf (viewed 26 June 2018)

The paper proceeds as follows. Section 2 provides a brief overview of the nature of agribusiness MIS schemes and history of failures in the sector. In Section 3, we provide an overview of the Quintis business model noting its similarities to those earlier cases of failure. Section 4 contains a brief outline of the Quintis experience in the lead up to and subsequent appointment of administrators, to identify the extent to which causes of failure were peculiar to Quintis or reflect more general problems with the forestry agribusiness MIS model. In doing so, our primary focus is upon the issues involving the MIS, rather than on the other non-MIS activities and governance of Quintis Ltd, although the two are significantly intertwined (which is one of the problems of the business model). Section 5 provides a brief overview of the similar issues arising from the Quintis and earlier failures. The regulatory responses regarding agribusiness MIS since the 2009 experience and recommendations of the 2016 Senate Inquiry report are considered in Section 6. Then, in Section 7 we review whether the policy responses address the key issues requiring attention, drawing on the Quintis experience. The concluding section outlines a policy agenda for regulatory reform.

2. Agribusiness MIS: operations and failures

Agribusiness Managed Investment Schemes (MIS) became popular in Australia in the late 1990s. By 2009 there were 371 licensed MIS and \$8 billion had been raised from investors (also referred to as “growers”).⁵ This was partly due to tax concessions for such investments⁶, but also because the structure provided a way for retail (and wholesale) investors to obtain financial interests in long term agricultural projects without the need for any operational involvement.⁷ Investors in such schemes face the usual future harvest and price risks inherent in agriculture, and are reliant on long term projections provided by scheme operators in assessing possible returns.

Such schemes are marketed and then operated on behalf of the investors by a company (often a subsidiary of an ASX listed company) acting as the RE. The RE is required to operate in the best interests of the MIS investors. But it (or its parent company) also has an objective of making profits for shareholders from: fee income for managing the schemes; margins on MIS-related operational activities contracted out to other members of the corporate group; and engaging in other (possibly unrelated) activities. The potential conflicts of interest are readily apparent.

Significant failures of many such RE’s and losses to their shareholders⁸ and investors in associated schemes in 2009 and subsequent years (see Table 1) reduced the general appeal of the sector. This was particularly so in the case of forestry agribusinesses, and meant major losses for the many (often levered) MIS investors and stakeholders in the RE company. The forestry MIS sector declined markedly

⁵ Parliamentary Joint Committee on Corporations and Financial Services, “Inquiry into Agribusiness Managed Investment Schemes”, September 2009, p14

http://www.aph.gov.au/senate/committee/corporations_ctte/MIS/report/report.pdf (viewed 26 February 2018)

⁶ Tax concessions arise from the ability of the investor to claim, provided certain conditions are met, a 100 per cent deduction of the investment from taxable income, with subsequent income from a successful project being taxed as ordinary income. This can be interpreted as, in part, a bringing forward of, and amplifying, tax concessions associated with capital gains if, instead, the initial investment was treated as a capital item. In addition, if the investment is financed by borrowed funds the interest expense on those borrowings is also tax deductible.

⁷ While investors in a project leased a specific part of the plantation associated with that scheme, some part of harvest risk was mitigated by them being entitled to a pro rata share of the overall harvest from the plantation.

⁸ For ease of exposition the distinction between a RE subsidiary and its parent company will be ignored in what follows except where it is relevant to the analysis.

such that by 2016 there were only three providers⁹ operating of which Quintis Ltd, was the largest still actively marketing such schemes. Quintis had raised \$248 million in upfront fees since 2002 from investors in its MIS schemes, from around 21,000 investors.¹⁰ In January 2018, Quintis Ltd was placed into administration, raising questions about the future management and viability of the 17 schemes under its management.

Table 1: Agribusiness Forestry MIS failures¹¹

Date	Name	Amount Raised (\$m)	Number of MIS managed	Number of Investors
April 2010	FEA Plantations	n.a.	17	13,000
May 2009	Great Southern	2,000	43	43,000
Sept 2012	Gunns	600	16	49,000
Feb 2008	Palandri	155	5	3,200
May 2010	Rewards Group	250	43	8,400
April 2009	Timbercorp	1,100	34	18,000
Sept 2010	Willmott Forests	400	14	8000

One consequence of the long running fallout from earlier failures was that the Senate had directed its Economics Reference Committee in June 2014 to inquire into forestry MIS schemes.¹² While failure of some businesses is a natural part of the economic cycle, the systemic forestry MIS failures had raised many issues warranting attention. These included: unsuitable business structures; conflicts of interest inherent in the RE model; inadequate information disclosure and financial advice; resolution arrangements and MIS management in the case of RE failures; and government policy (including tax treatment) of the sector. The Committee ultimately reported in March 2016 and made 24 recommendations which are considered later.

While the forestry MIS sector is now largely dormant (in terms of offerings of new schemes), that is no reason to believe that at some point in the future new schemes will not be created aimed at, largely, retail investors attracted by promises of high long term returns and tax concessions associated with such investments. Hence it is important to examine whether the Senate Committee's recommendations will, if implemented, be sufficient to prevent future repetition of past problems, and whether there are alternative approaches which might be more suitable.

3. Quintis: Background and Structure

Quintis Ltd was founded in 1997 under the name TFS (Tropical Forestry Services), listed on the ASX in 2004 and changed its name to Quintis (ASX code: QIN) on 22 March 2017. At that time it had a market capitalisation of approximately AUD 600 million and was included in the S&P/ASX 300 index. The company was engaged in developing sandalwood plantations both on its own account and for

⁹ Australian Government, n3, p12

¹⁰ Estimates derived from the individual MIS accounts. Since it is not possible to identify investors, it is likely that the number of distinct investors is less because of multiple investments over different years by some investors. The upfront investment amounts do not include subsequent annual management and lease fees.

¹¹ Source: https://www.ato.gov.au/uploadedFiles/Content/ATP/downloads/GEN_ATP_21849_TAS.xls (viewed 1 June 2018), scheme websites and media reports

¹² An earlier parliamentary review was by the Parliamentary Joint Committee on Corporations and Financial Services, n5

wholesale/sophisticated and retail investors, and initiating and acting as the RE for MIS to funnel investment into the sandalwood plantations. Its first plantings were in 1999 and its first MIS (East Kimberley Sandalwood Project No. 1) was opened for investment in 2000, with the crop being harvested in 2014. That duration of 15 years was the expected time to harvest of new plantations which would generate cash inflow following substantial upfront establishment expenses and ongoing annual maintenance expenses. Quintis was also engaged in post-harvest activities including extraction of sandalwood oil and heartwood (for use in carving) from the timber, and marketing and selling of the product.

Illustrating the mix of MIS management and other activities of the company, as at July 2014 the MIS plantations for retail investors of 3138 hectares were slightly larger than those for wholesale and sophisticated investors under the “Beyond Carbon” program (2723 hectares) and those directly owned by the company (1714 hectares).¹³ The expected revenue stream from the MIS to Quintis involved: payments by investor/growers of upfront establishment fees; annual interest income if the grower/investor borrowed from the finance company subsidiary (Arwon Finance); annual maintenance fees and lease income; and Quintis profits on post-harvest processing of wood purchased from the MIS. Investor/growers were able to defer payment of annual fees in exchange for Quintis acquiring part ownership of the harvest.

Table 2: Quintis Ltd Revenue (\$m) 2015-16¹⁴

Cash Revenue	175.5
Establishment Fees	95.0
Product Sales	29.9
Management Fees	28.8
Other	21.8
Non-Cash Revenue	93.3
Biological Asset Revaluation	76.9
Deferred Fees	16.2
Other	0.2

The dependence of Quintis Ltd on cash flow from MIS and wholesale/sophisticated investor establishment fees is shown in Table 2. By that time (2016) however, annual sales of plantations to MIS retail investors had become very small (67 hectares) relative to sales to institutional (521 hectares) and domestic sophisticated investors (588 hectares), or around 5 per cent of the total.

For projects initiated in the early 2000s, MIS establishment (first year) fees were in the order of 6 times subsequent annual fees (management and rent).¹⁵ But from 2006 this ratio began to increase to reach over 12 times in projects initiated in the years just before the Quintis failure. MIS investors were able, if they wished, to elect to not pay those annual fees in exchange for Quintis obtaining a specified share of the eventual harvest.¹⁶ An upfront payment of 1 year’s fees was also required and

¹³ TFS Corporation Ltd “Half Year FY2014 Financial Results”, Investor Presentation <https://www.asx.com.au/asxpdf/20140226/pdf/42n06cgs9tnvj.pdf>, p 15,(viewed 3 March 2018).

¹⁴ Source: TFS Corporation Ltd “FY16 Full Year results”, <https://wcsecure.weblink.com.au/pdf/TFC/01771970.pdf> (viewed 8 March 2018)

¹⁵ These were specified in the product disclosure statement to increase each year at 3.0 per cent p.a.

¹⁶ In 2012, for deferrals of the fees in years 1-2, 3-6 and 7-12, the shares were 3, 2, and 1 per cent respectively. The terms of deferral arrangements had gradually changed over time giving more incentive for investors to defer fees.

placed into trust to be released as payment for year 14 fees or earlier if the RE was placed into administration.¹⁷

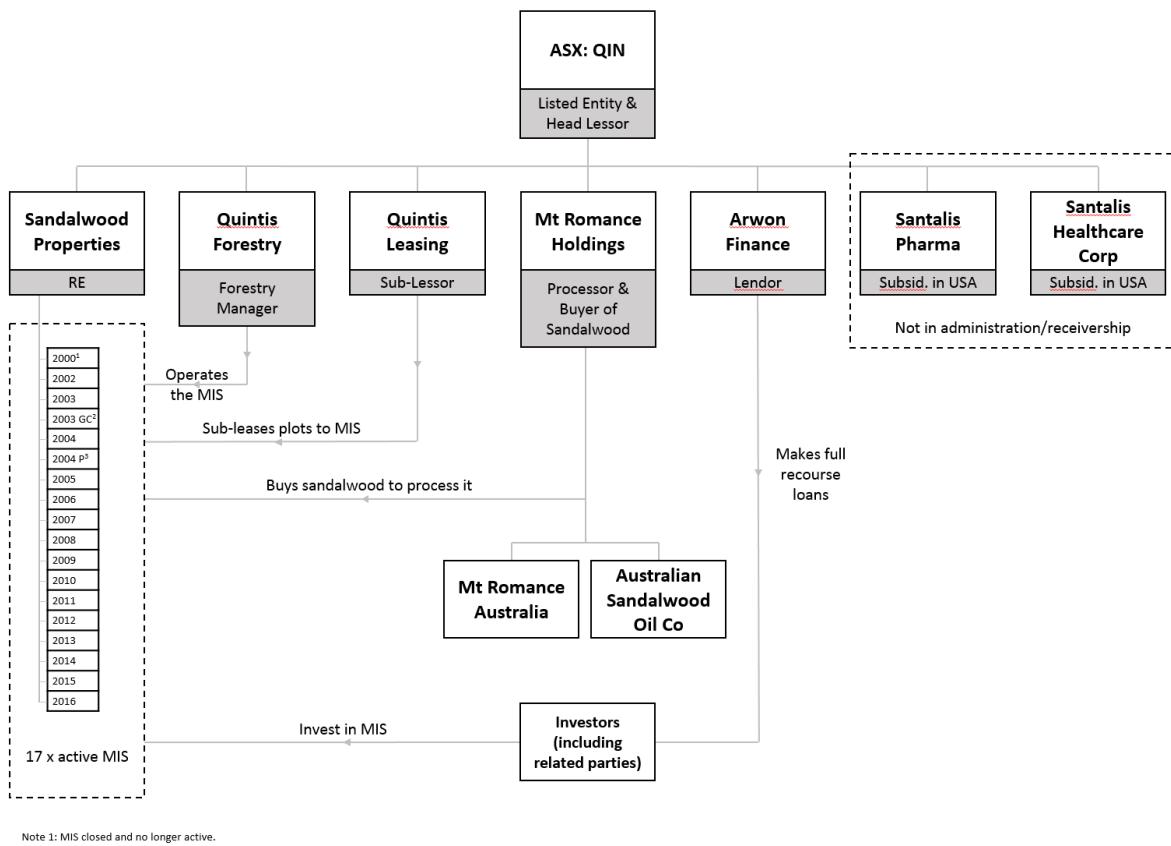
The expected revenue stream for Quintis Ltd from wholesale and sophisticated retail investors was similar to that from MIS other than that the land was purchased by the investors, no related party borrowings were made by wholesale investors (although sophisticated retail investors did borrow), and fees were earned from post-harvest processing activities. For company owned plantations, expected income consisted of post-harvest proceeds.

The organisational structure of Quintis (prior to its failure) is shown in Figure 1, and is similar to that which had been adopted by other agribusiness MIS schemes. The listed company (ASX: QIN) had multiple subsidiaries engaged in a range of activities related to the operation of the MIS as well as the company's own activities. One subsidiary is the RE for the (at 2017) 17 MIS, another is the manager of the forests, another leases the land on which plantations are established from QIN (which owns the land) and subleases them to the MIS, another is a buyer and processor of sandalwood from the MIS, and another is a finance company engaged in making full recourse loans to investors, including related parties. In addition, there are two US subsidiaries which are of limited relevance to the issues involving the MIS. The overall similarity with the structure of Great Southern (which failed in 2010) can be seen by comparing Figure 1 with Figure 2 in Brown et al (2010) (which also highlights the links between the RE and financial advisers involved in marketing the schemes to investors).¹⁸ The RE (Sandalwood Properties) would, on behalf of the MIS, engage and pay Quintis Forestry to undertake operational management activities, and would make lease payments to Quintis Leasing.

¹⁷ This provision would provide financing for a replacement RE to continue operations.

¹⁸ Brown, C., Davis, K., and C. Trusler "Managed Investment Scheme Regulation: Lessons from the Great Southern Failure" JASSA: *The Finsia Journal of Applied Finance*, 2010, 2, 23-28.

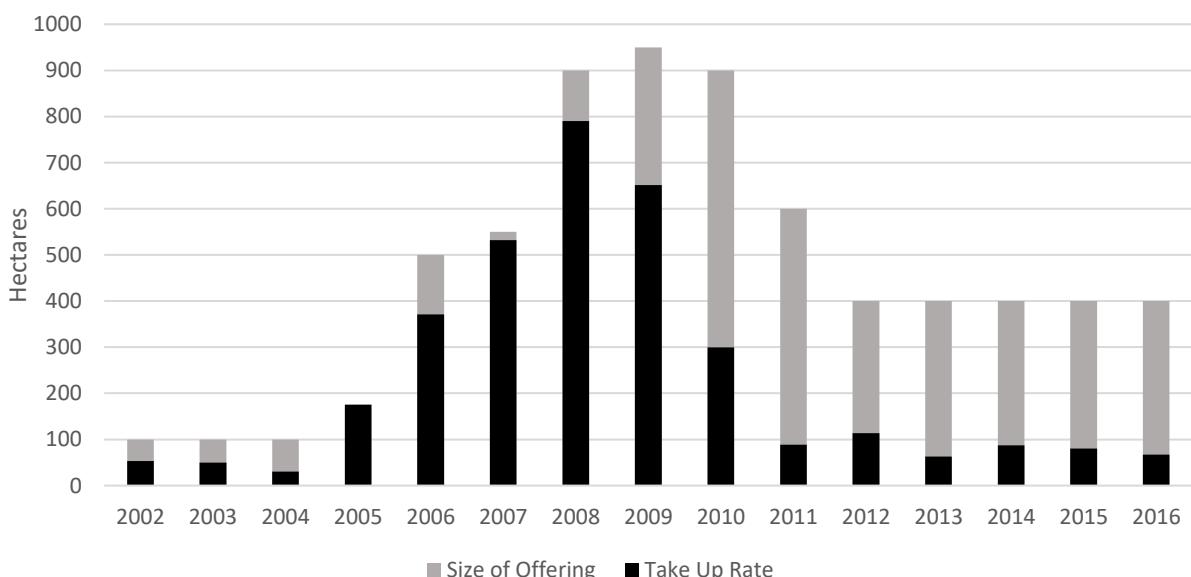
Figure 1: Quintis Ltd Structure



Note 1: MIS closed and no longer active.
Note 2: GC = Gold Card i.e. larger lots on offer.
Note 3: P = Premium i.e. larger lots on offer.

Like other agribusiness MIS, Quintis grew substantially in the years prior to the GFC, offering one new scheme per year of increasing size and with high take up rates from investors. After the GFC the size of offerings declined as did the take up rate (as shown in Figure 2).

Figure 2: Quintis Size of Offerings vs Take Up Rates

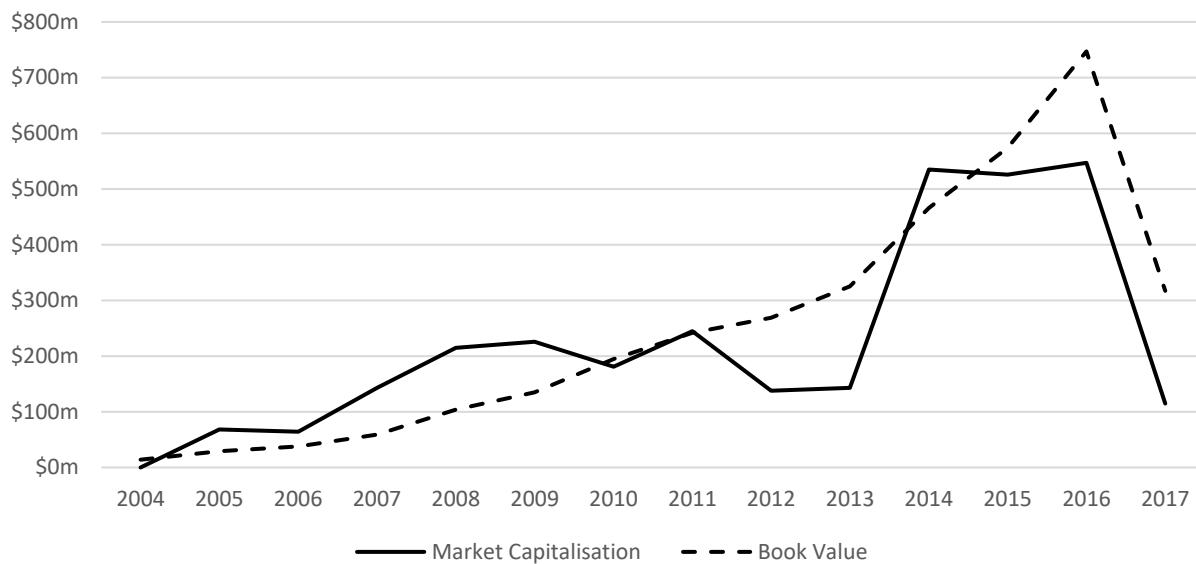


Likewise, the fortunes, in terms of share price, of the listed company reflected the behaviour of assets under management, at least until 2013 when a surge occurred in the share price from around 50 cents in mid-2013 to a peak of \$2.22 in mid-2014. (See Figure 3). That surge in the share price mimicked a steep rise in market capitalisation catching up with, and surpassing the ongoing growth in the book value of shareholders equity (shown in Figure 4). The 2013-14 share price surge, occurring at a time when sales of new MIS were subdued, appears anomalous given the ultimate dependence of the listed company on profits from managing such schemes.¹⁹ The increase in the book value of equity in 2016 resulted primarily from a significant equity capital raising to enable Quintis to acquire MIS grower interests in projects due to be harvested in the next few years. Ongoing revaluations of biological assets (plantations) were also an important (and subsequently controversial) source of increase in the book value of equity.

Figure 3: Quintis (ASX:QIN) Closing Share Price



¹⁹ A “good news” announcement published by the company on 29 August 2013 appears to have sparked a share price run-up from 47 cents the previous day to 58 cents that day and to a new plateau of around 80 cents until late November. That announcement included: a significant profit increase, reference to likely future increases in sandalwood prices and potential revenue from the soon to be harvested earliest MIS (and other) plantations, further investments by “institutional and sophisticated investors” in non-MIS plantations, and initiation of a franked dividend of 3 cents per share. From that time, the share price drifted upwards, until the start of 2014 when it jumped into the region of \$1.10 -\$1.20 despite no significant further announcements. A subsequent “good news” announcement on 26 February 2014, in relation to pharmaceutical uses for sandalwood oil, sparked a further run up in the share price from its value of \$1.17 at that time to the peak of \$2.22.

Figure 4: Quintis Market Capitalisation and Book Value

4. The Demise of Quintis

There were several events which served as a “trigger” for the rapid demise of Quintis Ltd (which had only recently received a credit ratings upgrade in mid-2016 from both Moody’s and S&P). These essentially brought the deficiencies in the business model and practices, including MIS arrangements, into sharp focus. One was the release on 21 March 2017 (coincidentally at the same time as the change of name from TFS to Quintis) of a highly critical report by Glaucus Research Group²⁰, a US hedge fund which had taken a short position in Quintis shares. It predicted that QIN would face the same fate as Great Southern and Timbercorp, arguing that the business model had similarities to a Ponzi scheme, much as Brown et al (2010)²¹ had argued was the case in their analysis of the failure of Great Southern. The share price fell from \$1.41 at that time to around \$1.10 within a few days.

The report also questioned the independence of “independent experts” whose projections of likely future harvest yields and prices were relied upon in the product disclosure statements.²² It noted an apparent inconsistency in the assumption that the future scale of Quintis output relative to a small world market for sandalwood products would not flood the market and reduce achievable prices. Additionally, the report also suggested that recent purchases of harvests from the 2000 MIS scheme by Quintis Ltd were designed to artificially elevate the market price to be more consistent with Quintis’ earlier projections.

²⁰ Glaucus Research Group “TFS Corporation limited / Quintis|ASX: TFC/QIN” <https://glaucusresearch.com/>, viewed 5 March 2018.

²¹ Brown et al (2010), n 18

²² One feature of marketing materials (such as in the 2014 Scheme product disclosure statement, pages 6 and 27) which appears to have not raised attention was the claim that there had been compound average growth in the price of sandalwood of 15.14% over the past 22 years. Details of the precise calculation are not available, but those figures relate to the Indian sandalwood market and the depreciation of the Indian Rupee against the Australian dollar against the USD and AUD would appear to account for around half of that growth rate.

Similar arguments were expressed in a research report²³ published shortly after by Viceroy Research in May 2017, a somewhat opaque entity (also a short seller) which has published a number of negative reports on listed companies in various countries.²⁴ The precise date at which the Viceroy report was made public is not clear but it was around the same time, 10 May 2017,²⁵ that a subsequent rapid share price decline began leading to a price of \$0.29 at 12 May 2017. (At that time the percentage of the company's stock reported as short sold increased from 0.01 on 9 May to 0.55, 0.39, and 0.35 (ten-plus times higher than the typical short sales position reported for other companies) over the following 3 days ending 12 May).²⁶

Both reports emphasised the role of biological asset revaluations (and the reliability of those estimates), rather than cash flow from operations, in underpinning both profitability and net assets of Quintis (see Figure 5 and Table 2). Those values were argued to be suspect because of: optimistic quality forecasts; the thin global market for sandalwood relative to forecast Quintis output volumes; and artificially inflated auction prices for the 2015 harvest of the 2001 MIS scheme arising from Quintis Ltd purchases. The value of some claimed supply contracts and non-disclosure of contract cancellations was also noted.

The reports also highlighted the increase in debt financing which had recently occurred implied that interest payments were reaching a very high and unsustainable proportion of "cash" profits, implying a need for further financing activities and risk of a vicious cycle. One source of that increasing leverage was the use by MIS grower/investors of the option to elect to defer annual maintenance payments in exchange for a forward sale of part of their timber at harvest to Quintis, requiring Quintis to raise funds for ongoing plantation maintenance. The strategy of Quintis also buying back grower interests in MIS was another cause of increased debt financing, and argued to be part of a process of limiting transparency of an inconsistency of MIS actual returns with those which had been projected.

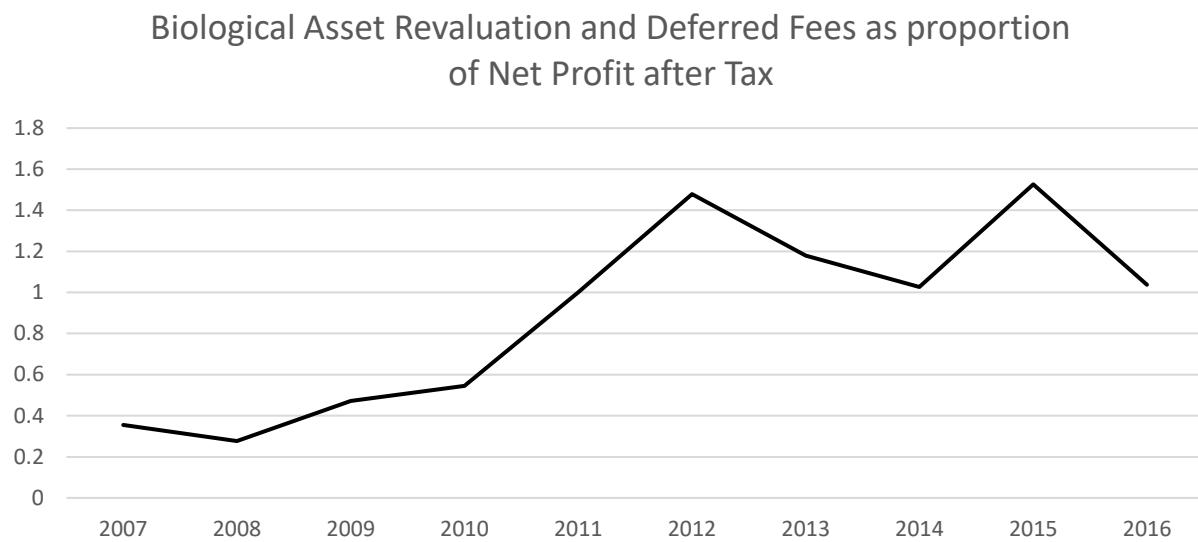
²³ Viceroy Research "Quintis Limited (ASX:QIN) – formerly TFS Corporation Limited – Money Doesn't Grow on Trees" <https://viceroyresearch.org/tag/quintis/>, viewed 5 March 2018.

²⁴ Jonathan Shapiro, Vesna Poljak and Tony Boyd "Viceroy's Australian links exposed after leaving digital trail" Australian Financial Review, January 18, 2018. <http://www.afr.com/markets/viceroy-s-australian-links-exposed-after-leaving-digital-trail-20180118-h0kj3> viewed 5 March 2018.

²⁵ A number of media references to the report from about May 14 can be found.

²⁶ Daily short sales data is provided by the ASX at <https://www.asx.com.au/data/shortsell.txt>

Figure 5: Quintis profit dependence on non-cash earnings²⁷



Ultimately it was cash flow problems which led to the demise of Quintis, with the defining event being the inability to meet obligations under two put options provided to (non-MIS) institutional and sophisticated investors in 2014 issues. Those options gave the holders the right to sell the plantations involved back to Quintis at fixed prices of \$34 million in April 2017 and \$51 million in September 2018 (which Quintis had reported in its 2016 Annual report as being very unlikely to be exercised, and thus not valued as a liability). In the event, some sophisticated investors attempted to exercise the option which, given insufficient cash holdings and inability to raise further borrowings, Quintis was not able to meet.

Quintis shares entered a trading halt on 15 May 2017, followed by voluntary suspension until appointment of voluntary administrators on 20 January 2018 and subsequent delisting. Over that period, a number of announcements were made regarding: entering into forbearance agreements over non-payment of interest with note-holders; inability to meet obligations of put options it had issued; failure of its subsidiary (Sandalwood Properties) to meet required conditions for its AFSL to act as a Responsible Entity; and commencement of class actions against the company. On 23 January 2018, the secured bond holders appointed Receivers and Managers to the group.

Soon after, Primary Securities²⁸ and the Sandalwood Growers Cooperative (formed by the former Quintis CEO and founder) tussled for control over some of the MIS on grounds that they could better protect grower interests. However, the pre-existing contractual arrangements between the MIS and various Quintis Ltd subsidiaries complicated matters and it was unclear whether grower ownership of the forestry assets would be forfeited under these new arrangements. Ultimately, in May 2018, the receivers (McGrathNicol) announced a recapitalisation plan that would enable the entity to continue as an unlisted company and, *inter alia*, continue as RE for the MIS.²⁹

²⁷ Source: Quintis (TFS) annual report

²⁸ Primary Securities “Qunitis Schemes: Proposal for 2003 to 2009 Scheme Growers” January 30, 2018.

<https://primarysecurities.com.au/wp-content/uploads/2018/01/Proposal-to-Growers-FINAL.pdf> (Viewed 12 March 2018).

²⁹ Poljak, Vesna “Bondholders back \$175m rescue plan for Quintis” *Australian Financial Review*, Friday June 1, 2018, p20.

5. Quintis and other Forestry Agribusiness MIS failure similarities

There are major similarities between the design and operational features of the Quintis MIS and those of Great Southern and TimberCorp which both failed in 2010.³⁰ First, forecasts of future harvest yields, quality and prices achievable appear to have been highly optimistic, and doubt exists about the independence of the forecasters involved. Second, transparency of ongoing performance available from annual financial reports was low due to the significant component of revenue attributed to unverifiable biological asset revaluations. Third, returns to investors in early schemes appear to have been effectively underpinned by various mechanisms including support of harvest price outcomes, repurchases of grower interests, and use of cash inflows from investors in later schemes. As well as masking the true performance of existing schemes, which could otherwise provide valuable information for potential investors in subsequent schemes, these practices suggest some “Ponzi-like” characteristics. Fourth, the parent company via a finance company subsidiary gave or arranged full recourse loans for retail investors, enabling them to take highly leveraged positions. Fifth, financial advisers received significant commissions (in the order of 5 – 10 per cent of amounts invested) for recommending investment in the MIS to their clients.

These issues have been addressed, but largely not acted upon, in a number of official responses to the 2010 failures which we now consider.

6. Regulatory Changes and the 2016 Senate Committee Recommendations

The 2009-2010 agribusiness MIS failures induced a number of regulatory responses and inquiries the first of which was a 2009 Report of the Parliamentary Joint Committee on Corporations and Financial Services.³¹ This spent much time discussing issues of MIS structure, failure management issues, tax incentives and their consequences, advice and sales practices, and information and disclosure issues, but made only three recommendations.

While its first recommendation called for consideration to be given to amending tax concessions (which would prevent negative gearing) for non-forestry agribusiness MIS, it stopped short of extending that argument to forestry schemes, partly based on the grounds that not enough time had elapsed for the consequences of a recent change imposing a 70 per cent DFE rule to be assessed.³² It recommended government monitoring of the effects of that change, and making changes to Division 394's integrity measures if required. There appears to have been no reports published subsequently assessing the consequences of the DFE Rule, and the relevance of the rule, as a means of limiting tax

³⁰ For analysis of the Great Southern failure see Brown et al (2010) n 18. The Timbercorp failure is analysed in Chapter 12 of Trevor Sykes, *Six Months of Panic: How the Global Financial Crisis Hit Australia*, Allen & Unwin, Crows Nest, 2010.

³¹ n5

³² The 70 per cent DFE (direct forestry expenditure on establishing, tending, felling and harvesting trees) rule applies to Forestry MIS investments made after 1 July 2007. It allows investors to claim a 100 per cent tax deduction for contributions if, *inter alia*, there is reasonable expectation that at least 70 per cent of contributions (calculated on a NPV basis) will be spent on DFE and participants hold the investment for at least 4 years. See <http://law.ato.gov.au/atolaw/view.htm?locid=%27PSR/PS20082/NAT/ATO/ft5%27&PiT=20080613000001> (viewed 6 March 2018).

evasion via incorrect claiming of tax concessions, to the economic merits of those concessions is unclear.

The 2009 Report's second recommendation related to resolution arrangements in the case of failure - suggesting ASIC appointment of a temporary RE when a MIS moves into external administration or liquidation. This recommendation has not been acted upon. Its third recommendation was that ASIC require disclosure of accreditation and expertise of third party providers of expert opinions on likely scheme performance. ASIC has responded to this recommendation in the following way.

In 2012 ASIC released Regulatory Guide 232³³ providing benchmark and disclosure principles for agribusiness MIS, to be applied on an "if not, why not" basis. These principles, shown in Table 3, reflected ASIC's perception of desirable characteristics needed for protection of investors in such schemes and RE arrangements. This approach reflected the fact that ASIC did not have a mandate to prudentially regulate such activities, but rather to ensure financial consumer protection and compliance of issuers of financial products with legislative and regulatory requirements. The PDS for the Quintis MIS indicate that it failed to meet benchmarks 1 and 5 and disclosure principles 1 and 4, while the Glaucus and Viceroy reports cast doubt on whether benchmark 4 was met. Specifically, the reports reveal that the data used to support price trends and projections was sourced from a supposed independent consultant who was also working as a biology and plantation consultant for Quintis.

Table 3: ASIC Regulatory Guide 232 Benchmarks

		Guideline met?
Benchmarks	1	Up front fees enough to cover life of MIS. Fees held separately
	2	RE and related parties own less than 5% of MIS
	3	RE provides annual reports
	4	RE engages independent experts
	5	RE only engages key service providers
Disclosure Principles	1	If RE or RP providing finance, must fully disclose.
	2	Disclose track record
	3	Disclose summary of RE financial position and if funding is needed
	4	Disclosure of rights to land, water, etc
	5	Disclosure of method to replace RE

The Corporations and Markets Advisory Committee had also produced a report in 2012 at the request of the Parliamentary Secretary to the Treasurer examining issues arising from situations in which the Responsible Entity or the scheme gets into financial distress.³⁴ ASIC in November 2013 issued a Class Order aimed at ensuring that land holdings associated with a scheme are registered in such a way as

³³ ASIC "RG 232: Agribusiness managed investment schemes: Improving disclosure for retail investors" Regulatory Guide 232, January 2012, <http://www.asic.gov.au/media/1246956/rg232.pdf> (viewed 26 February 2018)

³⁴ Corporations and Markets Advisory Committee, "Managed Investment Schemes", July 2012, [http://www.camac.gov.au/camac/camac.nsf/byheadline/pdffinal+reports+2012/\\$file/mis_report_july2012.pdf](http://www.camac.gov.au/camac/camac.nsf/byheadline/pdffinal+reports+2012/$file/mis_report_july2012.pdf) (viewed 26 February 2018). CAMAC identified particular problems for "common enterprise" schemes which were not relevant for the "pooled" schemes which are the subject of interest here, but also noted problems associated with having single entities which operated as the Responsible Entity (RE) for multiple schemes. It recommended a "Single Legal Entity" proposal under which the MIS rather than the RE would hold the property.

to ensure that those with interests in the scheme are appropriately protected and that the scheme can be operated efficiently, honestly and fairly.³⁵

Because of the special tax treatment of agribusiness MIS the Tax Office also provides, in addition to product tax rulings when a scheme is to be offered, advice on the tax consequences of scheme failures.³⁶

The 2016 Report of the Senate Economics References Committee on Agribusiness MIS made 24 recommendations, reflecting its conclusion that MIS failures reflected a number of key factors. These included:

“high upfront costs (sizeable commissions to financial advisers, funds diverted into the general working capital of the parent company, excessive overspending on administration and marketing); poor management decisions regarding the planting and location of the schemes; a business structure that depended too heavily on new sales for cash flow; and the lag time between initial investment and dividends.”³⁷ The Committee was also critical of government policy towards agribusiness MIS including: poor implementation of policy objectives, inadequate information on MIS performance, and poor understanding of tax incentive consequences.³⁸

The recommendations can be classified under several headings.

Information and Disclosure. Recommendations 1 and 8 deal with the information provided to potential investors. Improvements in product disclosure statements (PDS) are the subject of recommendation 8 while recommendation 1 calls for finding ways to ensure that investors do not interpret an ATO tax ruling for a product as an endorsement of its commercial viability.

Financial advice and product sales practices. These are the subjects of recommendations 2-7, 9-12, 19 and 24. They include general recommendations about the financial advice industry not specific to agribusiness MIS and for government policies to lift financial literacy levels. Measures to ensure research houses providing reports on financial products meet required standards of integrity and honesty are also recommended. Ensuring appropriate penalties for breaches of obligations by financial advisers and product manufacturers are also recommended. Recommendation 24 calls on ASIC to review investor complaints about advice provided for past agribusiness MIS and adequacy of powers and penalties available to it.

Agribusiness MIS Failure and Resolution. Recommendations 13 and 14 deal with achieving finalisation of issues still affecting investors in the failed TimberCorp and Great Southern schemes, while recommendation 18 suggests investigation of legal advice regarding repayment obligations of borrowers in failed schemes. Recommendation 20 suggests making legislative reforms to facilitate better resolution processes for MIS in financial difficulties.

Loan financing of MIS investments. This is the subject of recommendations 15-17. Bringing credit provided for investment purposes under the responsible lending provisions of the NCC and amending the Banking Code of Conduct to ensure lenders comply, improving borrower understanding of the

³⁵ ASIC Class Order 13/1406, 21 November 2013, <https://www.legislation.gov.au/Details/F2013L01986> (viewed 26 February 2018). A problem in some earlier failures related to the ability of schemes operating on leased land to effectively continue when the RE failed and was unable to meet lease payments to the land owners.

³⁶ Australian Taxation Office, “Collapse and restructure of agribusiness managed investment schemes – participant information”, <https://www.ato.gov.au/General/Tax-planning/In-detail/Collapse-and-restructure-of-agribusiness-managed-investment-schemes--participant-information/> (viewed 26 February 2018)

³⁷ The Senate Economics References Committee, n1, p xxiv.

³⁸ The Senate Economics References Committee, n1, p xxiv.

implications of recourse loans and investigating the merits of maximum loan/valuation ratio limits are proposed.

Tax Incentives. Recommendations 21-23 involve a call for investigating the consequences and merits of tax incentives for agribusiness MIS including consideration of overseas approaches and a recommendation for a review by the Productivity Commission.

The Government response to those recommendations was released in November 2016, explicitly rejecting only the call for a Productivity Commission review of tax incentives. For many of the other recommendations, the responses were either that the matters (a) required attention by parties other than the Federal Government, or (b) were not forestry agribusiness MIS specific. In that latter case, the Government highlighted policy measures to be implemented in response to the AFSI Final Report and its “capability review” of ASIC.

Among the general area of policy changes regarding financial advice and disclosure arrangements, which arguably encompass the Senate Committee recommendations, the Government pointed to a range of disclosure and financial advice reforms, including those outlined in its “Improving Consumer Outcomes in Finance” package released earlier in 2016.³⁹ Half of the Senate Committee’s recommendations deal with the issue of financial advice, and are broad brush in nature rather than specifically related to Agribusiness MIS. It is likely that the current Royal Commission⁴⁰ will lead to further changes in regulation of financial advice which will hopefully deal with, *inter alia*, the problems of supposedly independent financial advisors operating primarily as salespersons.

On the issue of MIS resolution arrangements, the response was to essentially defer consideration of this matter until the CCIV legislation was enacted. Regarding loan financing issues, the response was essentially to put this in the “too hard” basket, arguing that (a) bringing credit for investment purposes under the responsible lending provisions of the NCC would require State government involvement, and that (b) treatment in the Banking Code of Conduct was a matter for the banking sector.

7. An Assessment

Arguably, the recommendations of both Parliamentary Inquiries and the Government Response fail to address the fundamental flaws in agribusiness MIS models. Brown, Davis and Trusler (2010),⁴¹ in reviewing the failure of Great Southern, identify some such flaws and suggest a number of desirable changes to Agribusiness MIS regulation and practices. The Quintis failure indicates that these still remain relevant.

First, they argue that the RE model for MIS management in place since 1998⁴² is flawed in cases where the RE manages a number of MIS which are “opaque” in nature and combine significant operational activities with management of assets. Among the flaws are conflicts of interest and co-mingling of investor funds from different schemes and with the RE itself. The MIS model involving investor lock-in periods and funding arrangements for the longer term projects involved is also an issue, particularly

³⁹ Australian Government “Improving Consumer Outcomes in Financial Services”

<https://static.treasury.gov.au/uploads/sites/1/2017/06/ASIC-Capability-Review-Fact-Sheet.pdf> (viewed 26 June 2018).

⁴⁰ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

<https://financialservices.royalcommission.gov.au/Pages/default.aspx> (viewed 1 June 2018)

⁴¹ Brown et al (2010), n 18.

⁴² The RE model was introduced in the Managed Investments Act of 1998, but this was repealed in 2016 with the relevant provisions incorporated into the Corporations Act.

where deferral of investor fees (to be recouped from sales proceeds) may involve the RE taking on significant debt financing and risk of failure.

It is apparent, Quintis Ltd being an example, that the agribusiness activities can instead be conducted under a standard corporate structure with interested investors instead purchasing shares in the company. That does not tie investor returns to outcomes from a particular plantation and thus provides greater risk diversification and, if the company is listed, secondary market liquidity.

One explanation for the use of MIS schemes could be a perception of the founders that there are higher personal returns (and control benefits) to be made from profits made by the RE and associated entities than would occur from having a diluted equity position in the public company model. Since these benefits are at the expense of retail investors unable to fully assess the financial merits of the schemes, this would seem to provide little social or economic justification for the RE-MIS structure. Since MIS investors appear to have less control rights over the governance of the entity (via the RE) than would shareholders in a listed company structure, the case for use of the RE-MIS structure is further weakened.

A second explanation is that the forestry agribusiness MIS schemes are limited life entities, wound up when the plantation for that scheme is harvested, thus giving investors a determined investment horizon. They also involve required maintenance contributions from investors over the life of the scheme (which can be avoided by granting the RE a share of the final harvest proceeds). In practice, none of the agribusinesses appeared to be planning for a limited life, regularly rolling out new and replacement plantations, making a pure corporate structure a feasible option. The need for additional investor funding for maintenance etc between planting and harvesting of each plantation could be accomplished via a program of regular annual share rights issues.

A third explanation for use of MIS schemes rather than a corporate structure is because of specific agribusiness tax concessions provided and the general difference in tax treatment of MIS versus corporates. The up-front tax deductibility of amount invested essentially brings forward and augments the dollar amount of the tax concession on capital gains which would otherwise arise when the scheme is wound up.⁴³ This also has a present value advantage. Moreover, if the investor anticipates being in a lower tax bracket (such as in retirement) when wind up occurs, the dollar amount of tax benefit further exceeds the dollar amount given up. As noted by the 2016 Senate Committee Report (recommendations 21-23), and also by Brown, Davis and Trusler (2010),⁴⁴ there is a clear case for examining the merits of this special tax treatment – which would seem to primarily provide prospective tax benefits (albeit often ultimately unrealised) for high marginal tax bracket investors.

Further tax issues arise from the general differences in tax treatment of MIS versus companies. The MIS structure involves a flow through of income of the entity to investors without tax being paid at the entity level, but taxed in the investor's hands at their marginal tax rate. However, under the dividend imputation tax system, the ultimate effects of these differences for Australian investors are unclear. While, ultimately, a corporate structure might lead to investors receiving some part of returns

⁴³ The augmentation occurs because the full deductibility of the initial investment amount outweighs the fifty percent capital gains tax concession given up.

⁴⁴ Brown et al (2010), n 18

as dividends rather than MIS distributions, the dividend imputation system mitigates any tax consequences for Australian retail investors.⁴⁵

The trust structure also enables access to the concessional tax treatment of long term realised capital gains, whereas the corporate structure does not get concessional tax treatment of long term capital gains. Capital gains on sales of assets can lead to better post-tax outcomes for investors under MIS structures (where only half of long term capital gain is taxed) than under corporate structures (where full taxation of long term capital gains is not offset by the imputation system). However, the fact that Quintis Ltd, and other agribusiness entities, have found it feasible to hold plantation assets in the company structure (as well as in MIS on behalf of investors) suggests that there may be few general tax benefits (ignoring the special tax deductions for MIS investors) from using the MIS structure. Again, the tax arrangements for agribusiness investments (including what impediments to corporate structures exist) are an area warranting closer examination, as recommended by the Senate Committee Report.

A fourth potential benefit of the MIS structure is where the entity plans to increase its scale of activities by undertaking new plantation projects on a regular (eg annual) basis, with each requiring new capital injections by investors. The RE-MIS structure facilitates this via the RE being able to offer a new scheme under a new PDS each year. However, alternatives are readily available under a corporate structure. For example, the company could make regular renounceable rights issues to existing shareholders to raise funds for each plantation. Current investor/shareholders not wishing to make further investments could sell the rights to new investors.

Currently, the government is planning the introduction of CCIVs as an alternative company based structure, for passive managed investments, rather than the currently used trust structure. Flow-through tax treatment is envisaged (although details are yet to be legislated), ability to issue redeemable shares associated with the CCIV or its sub-funds, and CCIV management/governance by a single corporate entity comparable to the role of the Responsible Entity, are key features. However, there are no features of this proposed model which would imply that its use for Agribusiness Forestry managed investments would not suffer from the same problems as the current MIS model.

Brown et al (2010) also question the merits of allowing loan financing of investors using full recourse loans, particularly where the credit is provided by MIS operators or their associates. Sophisticated financiers who are better able to assess the risk of the schemes and with access to better information, should (it may be argued) be expected to bear risk of loss from failure of the investments for which they have provided loan finance. Under the current approach, MIS investors in failed schemes have been liable for repayment of funds borrowed – often from related parties of the RE.⁴⁶ While the Senate Inquiry Report discussed the possibility of only allowing non-recourse lending by related parties to the RE, as recommended by Brown, Davis and Trusler (2010)⁴⁷ it did not proceed down this path. Its recommendations 15-17, while with merit, do not go far enough. Imposing such a non-recourse requirement would undoubtedly increase the cost of borrowing funds by investors, whose risk would then be limited to own or other unrelated third party funds used to make the investment, and better

⁴⁵ There may be benefits where foreign investors are considered due to the withholding tax rate on trust distributions being below the company tax rate. However, given the special agribusiness tax concessions relevant only to domestic investors, the participation of foreign investors was limited.

⁴⁶ At June 2017, Quintis (via its subsidiary) had \$60.7 million grower loans directly outstanding plus a further \$16.6 million which it had sold to a third party, but with full recourse in the event of default back to Quintis. Source: Quintis Annual Report 2017, <https://quintis.com.au/media/1739/annual-report-2017.pdf> (viewed 3 June 2018)

⁴⁷ Brown et al (2010), n18

signal the risk associated with such investments.⁴⁸ Indeed, given the number of class actions related to lending by other financial institutions to enable retail investors to make such investments⁴⁹, a case exists for examining whether a wider application of this suggestion is warranted.⁵⁰

The Senate Inquiry recommendation 20 (and the CAMAC report) relates to finding improved arrangements for dealing with failures of MIS and/or their REs (as did the PJC 2009 Report which recommended giving ASIC the power to appoint a new RE). In the case of Quintis, a dispute was ongoing as at March 2018 about replacement of the RE, with the Sandalwood Growers Co-op having applied to ASIC for approval of such, and making a number of other claims regarding MIS management matters.⁵¹

The long-drawn out and controversial nature of the resolution of MIS arrangements of the Quintis failure illustrates the need for action in this regard, particularly if the RE-MIS agribusiness model is to be permitted to continue. Particularly relevant is the need to separate the role of the RE from provision of operational activities, such as by requiring outsourcing via competitive tender to unrelated parties.

The Senate Committee Report recommendations 1 and 8 relating to disclosure are clearly relevant in the Quintis case (particularly insofar as long term projections and roles of related parties are involved). Moreover, lack of disclosure about contracts cancelled and other matters raised by the Glaucus report illustrate the need for action in this regard. Recommendation 8 regarding finding ways to ensure that ATO tax rulings are not inappropriately interpreted by investors requires action, although would be redundant if the special tax treatment were removed from such schemes.

8. Conclusion

The substantial deficiencies of the forestry agribusiness MIS model and related government policies and regulatory arrangements were clear well before the most recent failure of Quintis Ltd. Several parliamentary reports have made recommendations for change. Some Government policy actions can be interpreted as implementation of some recommendations (disclosure, financial advice) but are more general in nature, arising from financial system-wide issues rather than being MIS specific. In any event, neither the Senate recommendations nor government policy changes go far enough towards preventing potential re-emergence of similar problems at some future date.

This paper has argued that more substantive changes are required. First, the special tax treatment of forestry agribusiness MIS schemes, which induces unsophisticated investors into opaque, high risk, levered investments, needs to be, at least, examined with an *a priori* expectation that existing concessions should be abolished. A Productivity Commission Inquiry (as recommended by the Senate Committee) which would examine the social and economic consequences of the tax concessions is an

⁴⁸ Limited recourse borrowing arrangements are sometimes used by financial institutions for providing customers with credit finance for equity investments.

⁴⁹ Court proceedings relating to loans associated with investments made in 2006 in schemes operated by Great Southern which failed in 2010 were still ongoing in 2018 with one judgement by the Supreme Court of NSW handed down on March 28, 2018. See <https://www.caselaw.nsw.gov.au/decision/5aaaf0f92e4b074a7c6e1d723> (viewed 3 June 2018).

⁵⁰ Yet to be implemented recommendations of the 2014 Australian Financial System (Murray) Inquiry (www.fsi.gov.au) about financial product suitability requirements and ASIC temporary banning powers could achieve this – provided they apply to credit products as well as financial products as narrowly defined in the Corporations Act.

⁵¹ See McGrathNicol “Circular to managed investment scheme growers – Quintis Ltd and its Australian subsidiaries (administrators appointed) (receivers and managers appointed)” <https://www.mcgrathnicol.com/app/uploads/A5-180308-PROJBIR03-Updated-response-to-SGC-March-update-AW.pdf> (viewed 23 June 2018)

obvious response. Second, since forestry agribusiness can be conducted under a corporate structure rather than via MIS structures, and would involve less conflicts of interest and governance problems, there is a need to examine what, if any, impediments exist to use of a traditional corporate structure. The CCIV model planned for introduction, does not appear to have within it anything that would prevent problems observed with the RE-MIS model re-occurring Third, conflicted financial advice remuneration and other arrangements which have led to significant poorly informed retail investor participation in such schemes warrants attention – which seems likely to occur more generally as a result of the current Royal Commission. Finally, there is merit in examining further the case for requiring loans made by financial institutions (particularly related parties to the RE) for such financial investments by retail investors in MIS to be made on a non-recourse basis.

It might be argued that worrying about deficiencies in the MIS business models used in the currently dormant forestry agribusiness sector is akin to closing the stable door after the horse is bolted. But, as Winston Churchill is reported to have said "Those that fail to learn from history, are doomed to repeat it."