Managed Investment Scheme Regulation: Lessons from the Great Southern Failure*

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Abstract:

In April/May 2009, two large ASX - listed companies which dominated the agri-business Managed Investment Scheme sector were placed into administration, leading to significant losses for investors in those companies and the schemes they operated. We provide a concise overview of the demise of one of these companies, Great Southern Limited, to identify a number of inadequacies in current investor protection arrangements.

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Introduction

Since the late 1990s, agribusiness Managed Investment Schemes (MIS) have been a popular form of investment for many retail investors, with much of that popularity attributed to special tax concessions associated with those investments. ASIC (2009) reports that in July 2009 there were 371 licensed agribusiness schemes of which 198 were forestry (plantations) and the remainder primarily horticultural, and that around $8 billion had been raised from 75,000 investors since the introduction of the *Managed Investments Act* in 1998.

The collapse within the space of one month in April/May 2009 of two of the largest operators of such schemes (Great Southern and Timbercorp), accounting for around 40 per cent of the industry, sparked a parliamentary committee inquiry (PJC, 2009a). That report makes three recommendations: the first is related to taxation arrangements; the second relates to arrangements when the Responsible Entity (RE) for a MIS is placed in administration, and the third relates to disclosure of qualifications of experts providing opinions on scheme performance. While there is much discussion of investor protection issues, no recommendations are made and those matters are considered more broadly in the committee's contemporaneous inquiry into financial products and services (PJC, 2009b).

We are of the view that there is additional value to be gained regarding investor protection issues from closer examination of the agribusiness failures, and thus examine the Great Southern failure in more detail below. The next section provides a brief overview of agribusiness MIS schemes, and this is followed by an overview of Great Southern's activities and failure which is used to identify a number of investor protection issues discussed in the subsequent section. Among those issues, which are not considered in PJC (2009b), are the suitability of the Responsible Entity regime for agribusiness (and more generally), disclosure to investors and the desirability of the RE providing or arranging loans for investors to participate in its schemes.

1. Agribusiness MIS Schemes

The agribusiness MIS structure brings together investors whose money is pooled and used in the production of agricultural or horticultural products on a large scale. Forestry MIS investors make an upfront payment with outstanding planting, management, harvest and other associated costs deducted from the proceeds of the (far distant) harvest (when the scheme terminates). Non forestry MIS investments, where regular harvests generate an income stream, generally require both an upfront payment and annual payments for rent and management fees for the fixed life of the scheme.

Even though the investor may have "ownership rights" to the trees or crop on a specific acreage, the MIS agreement provides that the harvest proceeds from the whole scheme are shared pro rata among investors according to their relative investments – thereby diversifying risk. The Responsible Entity (RE) which is the manager of the scheme agrees to plant, manage and harvest the product with the harvest proceeds net of outstanding costs and fees[1] being returned to the investor. (For livestock MIS, the manager has similar responsibilities). The land involved is owned or leased by the RE and sub-leased to investors in the MIS. Where the land is leased, failure of the RE to meet lease payments may see title to the trees or vines revert to the land owner or other third parties. The ability of the RE to demand further investment beyond that agreed is determined by the scheme's constitution and the investor is not personally liable for debts accrued in the running of the project. Figure 1 illustrates the typical structure of an agribusiness MIS.

[1] Inquiry into aspects of agribusiness managed investment schemes pg 5

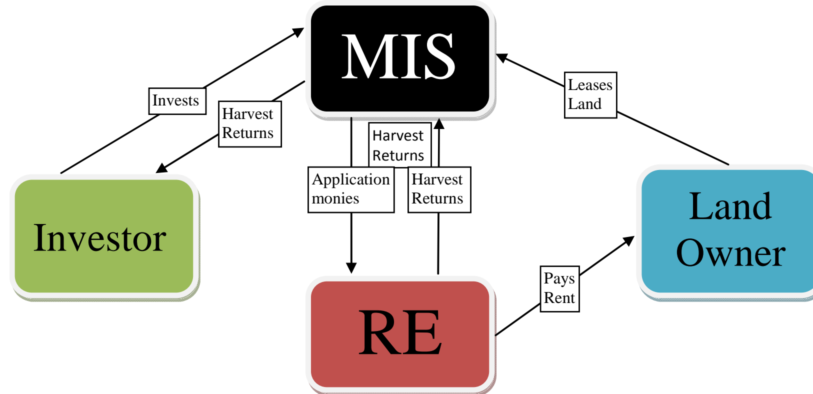

Figure 1: The structure of an agribusiness MIS

Agribusiness MIS operates under the 1998 Managed Investments Act regime, which introduced the concept of the Responsible Entity (RE), replacing the separate roles of trustee and manager. The Act requires the RE to be a public company meeting minimum capital requirements, to have an appropriate Australian Financial Services Licence, and requires officers of the RE to act in the best interests of investors in the MIS, and treat all investors equally. For large RE's, there is no requirement to appoint a separate custodian for assets of the MIS, and funds subscribed by investors in different MIS are ultimately transferred to the RE or its parent company. Thus, any invested funds remaining after the costs of establishing trees etc., and to be used for future expenses such as rental and management payments, are represented by a claim on assets of the parent company.

From the perspective of the RE, net cash flows associated with an individual forestry MIS take the form of: (a) initial year inflow (subscriptions net of establishment costs – marketing, commissions, planting etc.); (b) subsequent year outflows (maintenance, lease payments, and other expenses), the sum of which is significantly greater than the initial year inflow; and (c) final year inflow (recoupment of deferred expenses (item (b) above) from the harvest proceeds). To finance the interim year outflows (b), the RE (or its parent) will need to use its own equity, borrowed funds or the net initial year inflow from newly established MIS.

In principle, as long as the final year inflows are adequate, any combination of sources of funds is acceptable, and the lowest cost funding would appear optimal. However, if the approach used is that of creating new MIS to not only fund expenses of, but also provide unwarranted returns to, investors in earlier schemes, the structure has, at least, the appearance of a Ponzi scheme. Any subsidization of returns to investors in old schemes, motivated perhaps by a need to point to past investors returns to generate new interest, is not only inconsistent with the principle of scheme investors bearing the risk of their investment but exacerbates the risk of the RE becoming dependent on increasing growth in new MIS for survival. While not a Ponzi scheme per se, if promised returns to new scheme members are excessive, and returns provided to old scheme members are inflated relative to actual underlying returns, a Ponzi outcome of collapse is likely.

Part of the attraction of agribusiness MIS to retail investors has been the tax treatment afforded to them, whereby initial subscriptions (and ongoing contributions where applicable), as well as costs of borrowing to finance investment were allowable - in full - as a deduction from taxable income. Even though eventual harvest returns are taxable income, the deferral effect has advantages – particularly for those anticipating a lower marginal tax rate at that later time (such as in retirement). These timing benefits improved the projected after-tax rate of return – and led to concerns that the schemes were primarily tax-driven and as such did no more than to facilitate projects which otherwise, were not economically viable. Further evidence of this is the sharp decline in MIS subscription from its peak in 2006, reflecting proposed changes at that time regarding the tax treatment of non-forestry MIS.

. 2. Great Southern – Growth and Failure

Great Southern was founded in Perth in 1987, listed on the ASX in 1999, and at the time of its collapse (May 2009) was Australia's largest agribusiness MIS operator with over $2.2 billion invested by 52,000 investors. The group consisted of the ASX listed parent Great Southern Limited (GSL) and some thirty four subsidiaries, one of which was Great

Southern Managers Australia Ltd (GSMAL) operating as the Responsible Entity (RE) for 43 registered MIS.

Figure 2 provides an outline of the relationship between GSL, GSMAL (the RE), and a single MIS, and illustrates the complex nature of the business model. Investors in an MIS paid subscription monies to the RE, often on the advice of financial advisers who may have been employees of GSL (or a subsidiary) or independent, and to whom some part of the subscription was paid by the RE as a commission. (In Figure 2, the overlap of the hatched area, representing GSL, with the icons for financial advisers, service providers, and land owners, signifies that these entities might be part of GSL or independent). The funds remaining after commissions and other costs were used by the RE to lease land, establish the plantation or other agribusiness using services provided, or held by GSL to meet ongoing MIS expenses Ultimately, when the plantation was harvested (or annually in the case of most mature, non forestry schemes) investors would receive the proceeds (less some agreed fraction kept by the RE to cover certain expenses).

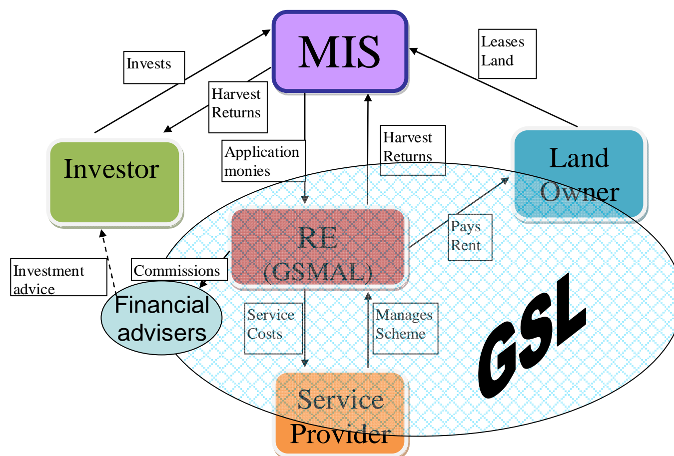

Figure 2: The structure of Great Southern

A further link not shown in Figure 1 is that of a lender borrower relationship between GSL and investors. By borrowing to finance the investment, the tax deductibility of interest payments prior to receipt of income created a further (negative gearing type) tax benefit, increasing the financial risk to investors. GSL was active as a lender (or arranger of loans) to investors in its MIS schemes, funding these loans by borrowing or securitizing the receivables.

Also not shown in Figure 1 is the effect of the company operating multiple MIS which were established at different points in time. Two consequences of this are significant. First, the assets of any individual MIS are not fully quarantined and so are available for use in other schemes. The MIS investor has "ownership" of a particular lot of trees or other plants, established when the scheme is set up. But the residual funds are deposited with the parent company GSL and thus, as a claim on the company's assets, co-mingled with those of other MIS (and other creditors) on the parent company. Indeed, GSL's revenue was dominated by new MIS subscriptions. Second, because the GSL business model was built on ongoing and increasing creation of new MIS for a revenue stream and finance source, problems of attracting new investors could arise if returns on existing/maturing schemes were inadequate. Hence, incentives may have existed for GSL (or a subsidiary), as purchaser of harvests (for on-sale), to apply some new investment inflows to subsidize returns to poorly performing old schemes in a "quasi-Ponzi" type structure.

The problems faced by Great Southern were many. Great Southern consistently produced forestry harvests well below forecasts contained in the Forestry Prospectus'. This risk could naturally arise from factors which can broadly be classified as 'agricultural risk'. A further reason, suggested to the PJC inquiry (PJC, 2009a) was the independence and reliability of agricultural experts used to justify forecasts, and the potential biases arising from the desire for repeat business, leading to the inquiry's recommendation for disclosure of qualifications of "experts". However, disclosure may not be sufficient as evidenced by Great Southern's record of expert-approved, gross overestimates of yield. Independent review of projections is sorely needed, but unlikely to emerge as a market

solution and not obviously an appropriate role for a regulatory agency such as ASIC to take on.

The poor harvests (and poor performance of woodchip prices relative to forecasts) also led to a situation in which Great Southern "topped up" the return to investors in early forestry schemes. Apart from the drain on the equity of GSL, or use of new MIS scheme funds, from subsidizing early MIS investors, this approach creates a complex interrelationship between GSL and investors in MIS schemes. Their returns become linked not only to the performance of their scheme, but also to that of GSL's overall activities more generally. GSL appears to have recognized the problems in this model when it introduced "Project Transformation" in 2008 aimed at converting MIS interests into shares in GSL. Unfortunately, the GFC and rapidly declining share price for GSL created problems for this process.

A further complication for GSL was the problems created by the Tax Office's proposal to change the tax treatment of non-forestry agribusiness MIS, which weakened investor interest in such schemes. Given the importance of new MIS subscriptions for the GSL business model, this was a major problem.

On April 23, 2009 Timbercorp Ltd., one of the other major agribusiness MIS providers was placed in administration. Great Southern followed quickly on May 15th.

Not only did shareholders and creditors of the parent companies face losses, but investors in what many would have expected to be stand-alone MIS schemes faced problems. The ability of a replacement RE in administration to provide funding for ongoing maintenance and harvesting was subject to significant impediments due to claims of creditors. For many investors in MIS, the full recourse loans they had taken out from GSL or other lenders were still obligations, even though the MIS investments they had funded were threatened with collapse and loss of value. In particular if the RE could not meet lease payments, the investor's proprietary rights in the plantation would revert to the lessor.

3. Policy Issues

As noted earlier the PJC Inquiry (PJC, 2009a) drew three recommendations from its review of agribusiness failures relating to tax, insolvency administration arrangements, and disclosure. The Committee's more general review of financial products and services (PJC, 2009b) made eleven recommendations including advocating greater disclosure and investor education, increased ASIC powers and supervision of advisors, giving advisors a fiduciary responsibility, improving self-regulation, and reducing commissions, and – if all else fails – considering an investor compensation fund. Its only recommendation specific to agribusiness MIS operators was that of requiring that they be able to demonstrate the adequacy of their working capital to meet obligations.

More fundamental issues need to be considered in the light of the agribusiness MIS failures such as Great Southern and Timbercorp.

First, it is far from clear that the Responsible Entity model introduced by the Managed Investments Act (MIA) of 1998 is optimal, with inherent weaknesses shown up by the stresses imposed by the GFC. As a model for the operation of an isolated MIS, it may have merit, but where the RE operates a number of MIS the requirement to place interests of investors in the MIS first, and treat all investors equally, is open to abuse. The decision by GSL to effectively ex post underwrite projected returns to investors in early schemes, certainly placed the interests of those investors first, but at the expense of investors in more recent schemes.

More generally, the nature of agribusiness MIS where there are significant operational activities required as well as "investment" creates potentially significant conflicts of interest in sourcing of those activities when the parent of the RE is an "in-house" provider. As noted in the PJC Inquiry "[t]here is currently potential for MIS to use unprofitable high cost structures to provide greater tax deductibility to investors, while directing a proportion of this tax-related investment to related entities charging above commercial rates for project services" (PJC, 2009, para 3.122, p45). Operational

efficiency may be enhanced by in-house rather than market based provision of such activities, but the question of whether the transfer pricing involved is fair to MIS investors becomes difficult to assess.

Internationally there are a variety of structures for Collective Investment Schemes, all of which aim to overcome the incentive problems, agency costs, governance and information problems that characterize such schemes as discussed in Blair and Ramsay (1992). One such issue is the ability of investors to discipline managers by "exiting" the scheme, and in this regard agribusiness MIS arrangements (with a lock-in period of currently four years) do not meet the IOSCO principles on withdrawal rights of investors (OECD, 2001). More generally, the information difficulties faced by investors in MIS schemes which involve significant operational expenses and long delayed returns suggest a need for a strong form of investor protection arrangements. While the RE model emphasizes the importance of "compliance" arrangements, that is quite different to "performance" and it is worth examining whether an independent trustee model would provide greater oversight and be better at resolving inherent conflicts of interest.

A second issue relates to the MIS operator providing or arranging "full recourse", high loan-to-investment ratio loans to investors to fund their MIS investment. Sophisticated investors may be aware of substantial risks associated with the investment such that project returns may be inadequate to repay obligations on such a loan. But such loan-investment packages are not always *marketed* as "high risk" (despite disclosure of the risks). There may be merit in requiring that loans for investments in MIS schemes, by MIS operators or associates, be made only on a "non-recourse" basis, such that the security is only the returns on the project rather than the investor's other assets. This transfers part of the risk of poor project outcomes for such loan-financed investments to the MIS operator-lender, who is better placed to assess such risks, and would likely induce lower loan-investment maximum limits. An alternative solution could be to impose a legislative maximum loan-to-valuation ratio as suggested by central banks in response to losses on mortgage loans in the Global Financial Crisis.

A third issue deals with the taxation concessions afforded to MIS investors, which can potentially distort investment decisions. Ultimately, the benefits of investor tax concessions may show up as subsidies to higher cost structure operations and/or returns to operators of such schemes, rather than inducing expansion of efficient investment. There have been numerous complaints about deleterious effect of agribusiness MIS schemes on traditional farming activities, including giving an artificial tax-induced boost to agricultural land prices (see Mackarness and Malcolm, 2006).

A fourth issue is the accuracy of the disclosure material for investors in agribusiness MIS. ASIC's Policy Statement PS 170 has led most MIS managers to provide projections of yields and prices, rather than cash flow projections, in the disclosure documents to retail investors. Projections of yield, harvest costs, and harvest (produce) value, independently are based on a myriad of complex factors each of which is exacerbated by the long investment horizon. Retail investors have limited ability to unravel the risks in such forecasts. Cash flow projections, coupled with correlation analysis that generates 'best' and 'worst' outcomes as well as probability of outcomes, might give investors a clearer picture of the risks involved in the investment.

4. Conclusion

The experience of agribusiness MIS schemes in recent years has raised a number of questions about the Responsible Entity Model used for such schemes following the passing of the Managed Investments Act in 1998. We have outlined a number of those issues above – and other concerns such as the role of agents of the RE as salespersons rather than financial advisors were aired in the PJC Inquiry. While the MIA was formally reviewed in 2001 (Turnbull, 2001) the timing of that review arguably gave insufficient time for any deficiencies in the RE Model to become apparent. Given the weaknesses made apparent by the Global Financial Crisis and the significant failures, such as outlined above, it is perhaps appropriate for a further review of the Australian approach to the design and regulation of Collective Investments.

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