Directors’ accountability in funds management companies

The complex legal and regulatory framework governing funds management creates particular challenges in mapping and understanding the duties and liabilities of directors and other officers of funds management companies. This article outlines an analytical framework for understanding officers’ legal accountability across the different institutional forms of funds management, including retail and wholesale managed funds, superannuation funds, life insurance products, investment companies and investment mandates.

IN RECENT DECADES, COMMERCIAL FUNDS management companies have emerged as important providers of investment products and services to Australian households. Assets under management in Australia’s commercial funds management industry now exceed $1 trillion on a consolidated basis, up from just over $600 billion in 2004.

Funds management is, in its legal aspects, a complex business to operate. Commercial funds management groups typically operate a range of different forms of collective investments. These include trust-based forms such as registered managed investment schemes, wholesale unit trusts, regulated superannuation funds, approved deposit funds and pooled superannuation trusts. A group may also include a life insurance company that offers (contractual) investment-linked life policies from its statutory fund or a listed investment company. It is likely also to manage discrete portfolios of assets for individual clients on a non-pooled basis, by way of an investment management agreement or mandate or through a managed discretionary account.

These businesses operate in a multi-layered legal and regulatory framework. Their activities may be governed by principles of trust law, contract law, or company law, and by fiduciary principles. Many of their activities are ‘financial services’ and, accordingly, the financial services laws (including the licensing, conduct and disclosure rules) also apply, as do the mandatory pre-sale and ongoing disclosure obligations of issuers of financial products to retail investors. In addition, the main retail forms of collective investment are subject to specific (and different) regulatory regimes covering their structure and governance, including (as applicable) Chapter 5C of the Corporations Act, the SIS Act and the Life Insurance Act. They are subject to regulatory oversight by ASIC, and where superannuation and life insurance are involved, prudential regulation by APRA.
Directors and officers
The directors and other officers of a funds management company are uniquely accountable for the conduct of that company’s business. A company’s directors include those persons appointed to or acting in that capacity. Its officers include those who make decisions affecting the whole or a substantial part of the company’s business.1

The various regulatory regimes covering funds management contain eligibility requirements and restrictions that must be taken into account in appointing (or allowing) individuals to act as officers. These may include having an appropriate level of experience and qualifications and being ‘fit and proper’ and of good fame and character.

Funds management businesses are often structured as corporate groups, with different companies in the group acting in these different capacities in relation to the particular products and services. The group’s officers may be employees of another company in the group. The composition of the board of directors of each of the companies may be different, and different from that of the parent company. In this case it is often important to ascertain whether a particular individual is an officer of the particular company, despite not being its employee.5

For the relevant general law and statutory requirements to apply, the person must be a director or officer of the company that is providing the funds management product or service in question. In the case of a registered managed investment scheme, that will be the company acting as the responsible entity. In the case of a superannuation entity it will be the trustee. For wholesale unit trusts and investment mandates, it will be the manager. For life insurance products, it will be the life insurance company, and in investment companies that are internally managed, it is the investment company itself.6

The different licensing regimes that apply to funds management sometimes require the company to nominate ‘responsible officers’ or a ‘responsible person’. As a general rule these regimes do not impose additional or special duties on these responsible officers or responsible persons, above those they have as officers of the company.

The pattern of accountability
In this complex legal and regulatory environment, it can be difficult for directors and other officers to work out the bases on which their individual legal accountability for the conduct of the funds management business arises. What is clear is that the legal and regulatory bases of accountability are not consistent across the different institutional forms of funds management. Put simply, this means that certain types of conduct in relation to, say, a registered scheme will be unlawful while the same conduct engaged in by an officer in relation to a superannuation entity will not. Nevertheless, it appears there are patterns of accountability that are consistent across the different institutional forms, although the content and intensity of the particular rules may differ.

When we look at the various bases for individual accountability across the funds management spectrum, what emerges is that officers’ duties and liabilities can be grouped into seven broad categories. Expressed normatively, these categories set out the seven things that an officer should have in mind in carrying out the functions attaching to his or her office, and in engaging in activities or dealings outside the scope of his or her office that may touch upon it.

Category 1: Unauthorised funds management activity
The first thing for the officer to consider is their potential personal liability for engaging in unauthorised funds management activities.

The regulatory framework for funds management requires that certain activities be undertaken only by persons who are appropriately licensed or authorised by the relevant regulator. It also requires that certain entities (including retail managed investment schemes, superannuation entities and life companies) be registered with or otherwise approved by the relevant regulator. People who undertake funds management activities without having complied with those requirements risk criminal and civil liability under the relevant statutes.

An officer who has participated in a contravention of the licensing or registration laws by the company faces potential liability under category 5, below. An officer who has engaged in that contravening behaviour personally can be made directly accountable for it in certain circumstances, explained here. These include where the officer has provided financial services, operated a registrable managed investment scheme, or offered financial products to retail investors, without the relevant regulatory requirements having been met.

Providing financial services
A person who carries on a financial services business without an Australian financial services licence contravenes s. 911A of the Corporations Act. In certain circumstances, courts have been prepared to treat individual officers as carrying on a business along with their company, so that both are considered to have contravened s. 911A.7

Alternatively, if an officer provides a financial service on behalf of the company, and the company does not hold an AFS licence (or is not exempt from licensing), the individual officer can contravene s. 911B of the Corporations Act by undertaking the physical activities that make up the provision of the service.8

Operating a registrable scheme
If any type of funds management arrangement is offered to retail clients in circumstances where there has been no effort at compliance, it is likely that the person will be treated as having offered an unregistered managed investment scheme. This is because the definition of a managed investment scheme operates as a residual category
into which collective investments that are not otherwise regulated, and that are not structured as companies, fall. Courts have consistently interpreted the definition broadly, to reflect its purpose as a means of prohibiting the offer of unregulated investment arrangements. A person who operates a registrable managed investment scheme without that scheme having been registered with ASIC contravenes the Corporations Act. As with s. 911A, courts have been prepared to treat individual officers as the persons ‘carrying on’ the scheme in certain circumstances, along with their company.

Offering financial products

An individual officer may contravene the statutory prohibitions on certain types of fundraising activity in connection with the funds management vehicle if he or she is considered to have engaged personally in the prohibited conduct. Examples would include publishing advertisements without including the appropriate ‘small print’, and hawking financial products. These statutory prohibitions are expressed to apply to ‘a person’, in contrast to the prohibition on offering financial products without a PDS, which applies only to a ‘regulated person’ and therefore to the company itself.

Traditionally, courts have tended not to treat individual officers as having made offers and published statements that are properly characterised as having been made by the company itself. In most cases, an officer’s liability in connection with a breach of the statutory prohibitions relating to fundraising can only arise on the basis discussed in category 5, below.

Category 2:

Breach of duty to the company

The second thing for the officer to consider is their duties, as corporate officers, to the company itself.

Like all company officers, officers of a funds management company are subject to statutory and general law duties owed by them to the company. These include duties to act with care and diligence and to exercise their powers and discretions in good faith in the interests of the company, and for a proper purpose. They also include fiduciary duties, owed to the company, that require them to avoid conflicts of interest and not to profit from their office. The officers’ accountability under this second category is to the company itself, not to investors. Officers’ direct accountability to investors arises (if at all) only under one of the other categories (most notably, category 4). The manner in which an individual officer must ‘prioritise’ his or her duties to the company against any (statutory) duty he or she may owe in relation to the operation of the funds management arrangement is discussed below, in connection with category 4.

It is worth noting that the officers of a company do not have an absolute duty under this category 2 to ensure that the company conducts its business in compliance with the statutory requirements relating to funds management. Of course, there may be situations where it is a breach of the officers’ duty to the company to authorise or permit it to commit contraventions of the funds management laws, because of the risk to the company’s interests in the ‘actual or potential exposure of the company to civil penalties or other liability under the [relevant] Act’. In these cases it may be a breach of duty for an officer to ‘embark on or authorise a course which attracts the risk of that exposure, at least if the risk is clear and the countervailing potential benefits insignificant’: ASIC v. Maxwell, above, at [104].

The fact that a company is a funds management company affects the operation of the officers’ duty of care to the company in an important way. Where the funds management company is in a fiduciary relationship with its investors, the officers’ duty of care to the company is affected by the application of the so-called ‘prudent investor rule’ and, in the case of trustees of superannuation entities, the prudence requirement in s. 52(1)(b) of the SIS Act. This is because the higher duty of care owed by the company to the investors is reflected in, and flows through to, the duty of care owed by the officers to the company.

Category 3: Breach of statute in relation to the provision of financial services

The third thing for the officer to consider is the statutory rules that govern their conduct in providing financial services as part of the business.

The Corporations Act and the ASIC Act impose a number of important requirements and restrictions on individuals who engage in conduct in relation to financial services and financial products. Among other things, the law prohibits a person from: engaging in misleading or deceptive conduct; engaging in dishonest conduct; acting unconscionably; engaging in certain prohibited conduct...
in relation to trading in financial products on a financial market; fraudulently inducing dealing in financial products; and engaging in insider trading. The law also prohibits a person from engaging in certain prohibited distribution practices in connection with the supply or possible supply of financial services or financial products.

Category 4: Breach of duty in relation to the operation of the relevant funds management vehicle

The fourth thing for the officer to consider is the specific duties imposed on them in relation to the operation of the particular funds management vehicle.

Responsible entities

Section 601FD of the Corporations Act imposes express statutory duties on the directors and other officers of a responsible entity that relate to the operation of its registered schemes. These include duties to: act honestly; exercise due care and diligence; act in the best interests of members and give priority to their interests, not make improper use of information or their position as an officer; and take steps to ensure appropriate compliance activities. Further, scheme transactions involving the company’s directors or director-related entities can require the approval of the members of the scheme in certain circumstances.

Superannuation trustees

Directors of superannuation trustees face personal liability under this category only where they have failed to take reasonable steps to ensure the company meets its statutory obligations to investors. They are required to exercise a reasonable degree of care and diligence for the purposes of ensuring that the trustee carries out each of the covenants contained in s. 52(2) of the SIS Act or in Regulations made under s. 52(5) of the SIS Act.

Life insurance companies

Section 48(2) of the Life Insurance Act requires that directors of a life company take reasonable care and use due diligence to see that, in the investment, administration and management of the assets of the company’s statutory fund, the life company complies with Part 4 of the Life Insurance Act and gives priority to the interests of owners and prospective owners of policies referable to the fund over the interests of shareholders.

Directors have a statutory obligation to use due diligence to ensure the life company complies with any notice given by APRA and must use due diligence to prevent a contravention of the Life Insurance Act in relation to the statutory fund that results in a loss to the statutory fund.

Trustee companies

All responsible entities and superannuation trustees, and many wholesale funds management companies, are trustees for their investors. This means that the company’s directors and agents are subject to a specific restriction, that arises under general law principles, that they cannot acquire trust property without the fully informed consent of the members of the trust.

Prioritising between the duties to the company and to investors

The fact that officers of (some) funds management companies owe (some specific) duties to investors under this category often leads people to ask: what is the relationship between the two sets of duties? In other words, what is the hierarchy? In deciding when and how to act, should an officer of a funds management company think of himself or herself primarily as being like a trustee for investors, or as an officer of a trading company (albeit one whose business is the business of selecting and managing investments on behalf of others)?

This question seems to arise most often in situations where the company and the investors are in a fiduciary relationship (particularly, in funds management vehicles structured as trusts). It is also raised, indirectly, by the rules relating to life companies’ statutory funds.

The position at general law (that is, outside the specific funds management statutes) is that a trustee company, not its officers, is in a fiduciary relationship with investors. The officers do not have any direct equitable or fiduciary duties to investors (other than the limited duty not to acquire trust property without informed consent).

So the question of the 'hierarchy of duties' does not arise for unregulated trusts – the officers’ duties are to the company and the legal rule is that they must always think of themselves first and foremost as officers of the company (albeit as officers of a trustee company). Of course, the social context of the arrangement may give rise to a different (non-legal) answer to that question.

The category 4 duties identified here disturb that general law position, by imposing on directors (and in the case of responsible entities, other officers) duties that are owed to investors directly. In each case, the ‘hierarchy of duty’ question is settled by the statute itself. Under s. 601FD (1) of the Corporations Act, an officer of a responsible entity is expressly required to give priority to the members’ interests if there is a conflict with the interests of the responsible entity. In the case of superannuation funds, s. 52 of the SIS Act expressly requires that the trustee’s duties and powers be performed and exercised in the best interests of the beneficiaries, and that its directors exercise a reasonable degree of care and diligence to ensure that the trustee carries out this obligation. Directors of a life insurance company are required to use due diligence to see that the company gives priority to the interests of policy holders under s. 48 of the Life Insurance Act.
Category 5: Participation in the company’s breach of law or duty
The fifth thing for the officer to consider is their potential liability for participating in a breach of law or duty by the company. This accountability can arise in one of four main ways; each of them is a form of accessorial liability as that term is generally understood by lawyers.

The first way: Breach of statute
The first is under statute, where the statute provides that involvement in a contravention by the company of a particular statutory provision is itself a contravention of the relevant Act. Examples include provisions in the Corporations Act relating to related party transactions, continuous disclosure, duties of a responsible entity and acquisition of interests in a registered scheme by a responsible entity.

The second way: Accessorial liability under statute
The second is under statute, where the law imposes civil liability on a person involved in a contravention without making that involvement itself a contravention of the law. Examples include s. 1325 of the Corporations Act (for breach of Chapter 5C and Pt 7.10 of the Act) and s. 55 of the SIS Act (for breach of the superannuation trustee’s covenants). The effect of these sections is that where an officer (or any other person) is involved in a contravention by the company of the relevant law, the person harmed by that contravention can recover against the person involved as well as the company.

The third way: The rule in Barnes v Addy
The third is under general equitable principles, in accordance with which a person who knowingly assists a fiduciary in a breach of that fiduciary’s duty is made accountable to the person to whom that duty was owed. An officer can be held accountable to investors where the company owes fiduciary duties to the investors (for example, because it is a trustee) and the officer 'knowingly or recklessly assists in or procures a breach of trust or breach of fiduciary duty' by the company: Finn J in ASC v. AS Nominees (1995), at 475. As Finn J goes on to point out in that case, 'this form of liability is one of no little significance to the directors of a trust company for the very reason that, often enough, it will be their own conduct in exercising the powers of the board which causes the company to commit a breach of trust'.

The fourth way: Criminal complicity
The fourth relates to situations where the company has committed a criminal offence under Commonwealth law. Under Pt 11.2 of the Criminal Code, a person who is culpably involved in the commission of an offence is taken also to have committed that offence. Section 11.2 of the Criminal Code provides that 'a person who aids, abets, counsels or procures the commission of an offence by another person is taken to have committed that offence and is punishable accordingly'.

Accessorial liability requires ‘knowing’ involvement
As a general rule, an individual officer can only be held legally accountable under category 5 where they have knowledge of, and participate in, the company’s contravention. In this sense their liability under all four types of category 5 accountability is direct and not derivative. In other words, they can be held accountable only on the basis of what they knew and did, and not merely because they hold a particular office or perform particular functions within the company.

Because their liability under each of the four types of category 5 accountability is accessorial in character, the law ‘focuses on the actual level of awareness and involvement of an individual in a contravention, not simply whether the person is a director or other officer of a corporation’. Essentially, the person must have knowledge of the essential matters which go to make up the company’s contravention, whether or not he or she knows those matters amount to a contravention.

The fact that the funds management laws are so complex (particularly the parts of the law dealing with the provision of financial services) and that so many of the offence provisions that apply to the company itself are strict liability offences, mean that officers face a real risk of accountability under category 5 even where they were unaware that what they were causing the company to do was in breach of one of the funds management laws. It is important to remember that ignorance of the law is not a defence.

Category 6: Defective disclosure
The sixth thing for the officer to consider is their accountability for defective disclosure or other information failures in relation to the funds management vehicle or arrangement. Directors and officers can be liable if they themselves make false, misleading or deceptive statements in relation to the products or services offered. They can also be liable in certain circumstances (generally where there have been failures of due diligence) in relation to the company’s disclosure in documents required by the applicable laws.

Generalised prohibitions on misleading or deceptive conduct and the making of false or misleading statements apply both to the company and to the individual officers. Specific liability regimes apply to the different forms of mandatory disclosure including pre-sale disclosure (that is, Product Disclosure Statements or, for investment companies, prospectuses), periodic disclosure (that is, annual and half-yearly financial reports and statements), continuous disclosure, and disclosure in connection with takeovers (for listed schemes and investment companies). These regimes extend liability for defects in the disclosure documents to the company’s directors and other officers in certain (differing) circumstances.

As a general rule, Chapter 7 of the Corporations Act (which deals with financial products and financial services) does not provide for accessorial civil liability for
Where the legislation imposes on a financial services licensee or product issuer an obligation to provide some kind of disclosure to investors, responsibility for that disclosure rests with the company itself. The exception is in connection with defects in a PDS, for which an officer can have civil liability under s. 1022B of the Corporations Act.

ccontraventions of the mandatory disclosure requirements. Where the legislation imposes on a financial services licensee or product issuer an obligation to provide some kind of disclosure to investors, responsibility for that disclosure rests with the company itself. The exception is in connection with defects in a PDS, for which an officer can have civil liability under s. 1022B of the Corporations Act.

Accordingly the enforcement provisions in Division 7 of Part 7.7 of the Corporations Act do not impose civil liability on a company's officers for defects in the financial services disclosure required under Part 7.7 of the Corporations Act (such as the Financial Services Guide), even where they are involved in a contravention in a broad or narrow sense. However, involvement in the commission of an offence by the company under Part 7.7 may give rise to accessorial criminal liability under Part 11.2 of the Commonwealth Criminal Code. The liability regime for the additional periodic and ongoing disclosure obligations imposed on product issuers under Division 3 of Part 7.9 of the Corporations Act, contained in Division 7, is similar.

Sections of the Corporations Act and ASIC Act create certain specific offences related to misstatements that induce people to acquire or dispose of financial products and financial services. An officer may incur liability where he or she engages in the conduct directly, or is involved in a contravention by the company.

Some examples of possible offences are as follows. An officer may be liable for defects in a PDS where the officer was involved in its preparation and directly or indirectly caused it to be defective or contributed to it being defective. An officer may be liable for defects in a prospectus (for an investment company) if he or she was involved in its preparation, subject to certain defences, including a due diligence defence. Similarly, officers who are involved in contraventions of the continuous disclosure laws (where they apply to registered schemes and investment companies) may be liable. A director can be liable for defects in takeover documents in certain circumstances. A director of a company, registered scheme or disclosing entity may contravene the law if they fail to take all reasonable steps to comply with, or secure compliance with, the periodic reporting requirements of the Corporations Act. There is also criminal liability for false or misleading Corporations Act documents and filings and information failures committed by officers and employees in communications with directors, auditors, members, and market operators.

Category 7: Debts improperly incurred
The final thing for directors to consider is their potential liability for debts improperly incurred by the company in the course of carrying out its funds management activities.

Directors can be held personally accountable in respect of debts incurred by the company in two important instances. The first is where the company incurs a debt while it is insolvent or that causes its insolvency, under s. 588G of the Corporations Act. The second is where the company is a trustee and it incurs a liability in breach of trust, under s. 197 of the Corporations Act.

Accountability to whom?
The complexity of the pattern of officers’ accountability in funds management companies carries through to the question: to whom are officers accountable where they contravene these duties? Depending on the specific terms and source of their duty, they may be answerable to the company itself, to investors, to creditors or to the State.

Liability to the company
Officers of a funds management company incur liability to their company where they have acted in breach of their duties to the company, or where the company has suffered loss or damage (for example, by being sued by investors for a corresponding breach of duty by the company) as a result of a contravention of statutory duty imposed on the officer that relates to the provision of financial services or the operation of the company’s funds management vehicles.

Liability to investors
Officers can be liable to investors for breaches of the duties imposed on them directly by the various statutes that relate to the provision of financial services or the operation of the funds management vehicles. In circumstances where the company is in a fiduciary relationship with investors (that is, in registered managed investment schemes, wholesale unit trusts, superannuation entities and investment mandates), officers that knowingly assist in a breach of duty by the company can be personally liable to investors under the rule in Barnes v. Adly. They can be liable to investors for defective disclosure in connection with the products and services offered by the company.

Liability to creditors
Officers can be personally liable to creditors in respect of debts incurred by the company in carrying out its funds management operations, in certain limited circumstances.
These may include where the company has incurred a debt when it is insolvent or that causes its insolvency, or where the company is a trustee and it has incurred a liability in breach of trust.

**Liability to the State**
Various public law sanctions may apply to breaches of law by officers, and to involvement by them in contraventions of law by the company. These create accountability to the State through exposure to civil, criminal or administrative sanctions. The Corporations Act, the ASIC Act, the SIS Act and the Life Insurance Act each create a number of criminal offences related to funds management activities that apply to the officers personally, or to the company, or to both. Culpable involvement by an officer in the commission by the company of a criminal offence creates accessorital criminal liability in the officer. Contravention of applicable civil penalty provisions, or a criminal conviction, may result in an officer being disqualified from participating in the funds management industry in the future.

**Conclusion**
This brief survey of officers’ accountability in funds management companies necessarily raises more questions than it answers. The research shows that while an overall pattern of accountability can be found, there is clear divergence in the approach to, and intensity of, officers’ accountability across the different forms of collective investments, particularly in category 4. This raises the question: to the extent that the various activities undertaken by funds management companies are functionally equivalent (if they are), is it appropriate that the pattern and degree of officers’ accountability varies in this way? The primary purpose of the taxonomy proposed here is to provide an analytical framework for addressing that larger question.

**Notes**
1. I am grateful to Howard Pender and to an anonymous referee for their helpful comments on earlier drafts of the paper.
2. For more detail on the issues addressed in this paper see P. F. Hanrahan 2007, *Funds Management in Australia: Officers’ Duties and Liabilities*, LexisNexis Butterworths, Sydney. The publisher’s permission to make use of parts of that text in this article is gratefully acknowledged.
4. For example, where the parent company is a listed entity, it may have a board comprising of a majority of non-executive directors, while the operating subsidiaries may have wholly executive boards.
6. That is, investment companies whose own employees undertake the investment activities and that have not contracted with an external manager to manage the company’s assets and investments for it.
8. By virtue of s. 766B(3) of the Corporations Act, a person’s conduct is not the provision of a financial service if it is done in the course of work of a kind ordinarily done by clerks or cashiers.
10. This arises if the company is a trustee for investors or where the company is an agent of the investors. In other cases the relationship may be treated as fiduciary where the company has undertaken to act in the interests of the investors and not in its own interests (for example, under an investment mandate).
11. The prudent investor rule is the rule that the exercise by a trustee of its investment powers is subject to a ‘requirement of caution’ that reflects the fact that the funds under its control are trust funds: see *ASC v. AS Nominees Ltd* (1993) 33 ACSR 403.
12. ‘Involved in a contravention’ is defined in s. 79 of the Corporations Act. A person is involved in a contravention if, and only if, the person: (a) has aided, abetted, counselled or procured the contravention; or (b) has induced, whether by threats or promises or otherwise, the contravention; or (c) has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or (d) has conspired with others to effect the contravention. An identical definition of involvement is contained in s. 17 of the SIS Act.
13. In contrast, directors can have derivative liability under categories 6 and 7.
14. See Corporations and Markets Advisory Committee (CAMAC) discussion paper *Personal Liability for Corporate Fault* (May 2005), n. 37, at [3.3].
15. A strict liability offence is one in relation to which it is not necessary for the prosecution to establish a fault element – that is, there is no need to show intention, knowledge, recklessness or negligence. However, a defence of mistake of fact is available. See ss. 5.1 and 6.1 of the Criminal Code.