

1 November 2010

Roger Paul  
Taxation of Financial Arrangements  
Business Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Dear Mr Paul

**Taxation of Financial Arrangements  
Subdivision 230- E Hedging Election**

The Financial Services Council (FSC) is the peak body representing Australia's retail and wholesale funds management superannuation and life insurance industries. The FSC has over 135 members who are responsible for investing over \$1.4 trillion on behalf of more than ten million Australians.

We refer to our last meeting concerning the Subdivision 230-E TOFA hedging election.

In that meeting you raised further questions relating to the granting of a proposed exemption from the requirement for taxpayers to have a valid hedge under the accounting standards as a prerequisite to making the subdivision 230-e election. The purpose of this letter is to answer those questions.

We would welcome the opportunity to further discuss the resolution of this issue. As we have previously advised, this is the most important TOFA issue affecting the financial services industry and we would prefer for it to be resolved as soon as possible.

If you have any questions regarding the FSC's submission please do not hesitate to contact Pravin Madhanagopal or myself on (02) 9299 3022.

Yours sincerely

**MARTIN CODINA**  
Director of Policy

## Question 1

### What types of entities should be subject to the proposed exemption?

In our last meeting, we discussed a condition you wished to place on the granting of the exemption from the Subdivision 230-E requirement for taxpayers to have a valid hedge under the accounting standards as a prerequisite to making the Subdivision 230-E election

This condition was a requirement for funds to obtain external auditor certification to the effect that hedge accounting cannot be adopted by the fund solely because the fund marks to market hedges in their financial statements.

We suggested as an alternative to this requirement, that those funds which are subject to a strict regulatory regime should not be required to obtain this audit certification. The basis for this proposal is that highly regulated entities are very unlikely to act in a dishonest manner in order to be able to make the Subdivision 230-E hedging election. Therefore such entities should not be required to incur the not insignificant costs and effort of obtaining independent certification of the reasons why they are unable to satisfy the Subdivision 230-E requirements.

We suggest that the following two types of entities are subject to sufficiently strict regulatory regimes for these purposes:

- Complying Superannuation Entities
- Managed Investment Trusts (as defined in Division 275 of the ITAA 1997)

### Complying Superannuation Entities

The Superannuation Industry (Supervision) Act 1993 (SISA), primarily governs the operation of superannuation funds and apply to all complying superannuation entities.

The SISA sets out the rules that a complying superannuation fund must obey. The rules cover areas relating to the trustee requirements, investments, management, fund accounts and administration, enquiries and complaints.

SISA provides for substantial penalties for trustees when the rules of operation are not satisfied by a fund. SISA also requires trustees to file annual returns that demonstrate a superannuation fund's compliance with the law.

The Australian Prudential Regulatory Authority regulates superannuation funds. APRA regulates the financial services industry generally and ensures that superannuation funds comply with the Superannuation Laws. In addition to the oversight from APRA, the Australian Securities and Investment Commission ensures that trustees provide information to superannuation fund members; the ATO regulates employer contributions, co-contributions and the superannuation tax rules; and the Superannuation Complaints Tribunal provides dispute resolution for formal complaints.

Details of the SISA regulatory requirements for superannuation funds are provided at Appendix 1. We draw your attention particularly to Section 52(2) of SISA which provides that the trustee:

- (a) act honestly in all matters concerning the entity; and
- (b) exercise in all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide.

In addition the trustee of a superannuation fund must under SISA section 29E satisfy conditions imposed on its AFSL including:

1. The RSE licensee must have a risk management strategy (section 29H) that complies with the law and sets out to apply to identify, monitor and manage risks that arise:
  - (i) in relation to its activities, or proposed activities, as an RSE licensee; and
  - (ii) in relation to all its other activities, or proposed activities, to the extent that they are relevant to its activities, or proposed activities, as an RSE licensee.
2. A risk management strategy must set out reasonable measures and procedures that a body corporate or group of individual trustees is to apply to identify, monitor and manage:
  - (i) the risks associated with governance and decision-making processes;
  - (ii) the risks that arise as a result of entering into outsourcing arrangements (other than arrangements that relate only to a particular registrable superannuation entity);
  - (iii) the risks arising from any changes to the RSE licensee law; and
  - (iv) the risks of potential fraud and theft.
3. An RSE licensee must:
  - (i) ensure that at all times its risk management strategy is up to date;
  - (ii) ensure that its risk management strategy is reviewed at least once each year to ensure that it complies with section 29H; and
  - (iii) modify, or replace, its risk management strategy in accordance with section 29HB if at any time the RSE licensee becomes aware that the risk management strategy no longer complies with section 29H.

### **Superannuation Funds – Conclusion**

These requirements impose high standards on superannuation fund trustees to act in an honest, prudent manner, focus on issues of risk management. These requirements as well as the common law fiduciary duties owed by a trustee to beneficiaries (which apply to all superannuation funds as they are trusts) are in our view more than adequate grounds for Treasury to accept self certification by superannuation funds of the reasons why they currently cannot make the Subdivision 230-E TOFA hedging election.

### **Managed Investment Schemes**

A managed investment scheme is a scheme (often in the form of a unit trust) in which people contribute money to acquire interests in the scheme. These contributions are pooled or used in a common enterprise and members of the scheme do not have day to day control over the operation of the scheme. All Managed Investment Trusts (as defined in Division 275 of the ITAA 1997) must be managed investment schemes.

Because managed investment schemes (MIS) are offered to the public there are numerous regulatory requirements that must be satisfied by managed investment schemes in the interests of investor protection.

### **Summary of MIS Regulation**

A Responsible Entity (“RE”) must be appointed to an MIS. The RE has the dual role of trustee and manager of the scheme. An RE must be an Australian public company holding an Australian Financial Services Licence to act as an RE. The RE must meet minimum net tangible asset requirements.

The Corporations Law imposes extensive duties on the Responsible Entity and its officers. These include the duty to act honestly, exercise a reasonable degree of care and diligence, act in the best interest of members of a scheme and to treat scheme members equally.

Details of the regulatory requirements that must be satisfied by MISs are provided at Appendix 2. We draw your attention particularly to the following regulatory requirements applicable to MISs.

### *Section 601FC(1) and 601 FD (1) – Duties of a Responsible Entity*

This provision outlines a series of duties owed by a Responsible Entity and its officers in exercising its powers. Among other obligations, the Responsible Entity and its officers must act honestly and in the best interests of the members. If there is a conflict between the members' interests and the officer's own interests, they must give priority to the members' interests

### *Section 912D – Obligation to notify ASIC of certain matters*

If an AFS Licensee significantly breaches, or is likely to significantly breach, a financial services law, they must notify ASIC in writing within 5 business days after becoming aware of the breach or likely breach.

### *Section 912E – Surveillance checks by ASIC*

An AFS Licensee and its representatives must give such assistance to ASIC as ASIC reasonably requests in relation to whether the Licensee and its representatives are complying with the financial services laws, and in relation to the performance of ASIC's other functions.

Breach of a duty by a Responsible Entity attract civil penalties (up to \$1 million for the Responsible Entity and up to \$200,000 for its relevant officers) and in some cases criminal sanctions. Where the Responsible Entity has less than \$5 million in net tangible assets ASIC requires it to appoint a Custodian to hold the assets of the scheme.

Managed investment schemes must prepare a Compliance Plan, usually in conjunction with the scheme's auditors. The Compliance Plan must set out the details of the measures which a Responsible Entity is to apply in operating the managed investment scheme to ensure compliance with the Law and the scheme's Constitution. Chapter 5C of the Corporations Law and ASIC's policies set out the requirements for a Compliance Plan which include ensuring: scheme property is clearly identified as such and held separately from other scheme property and property of the Responsible Entity, scheme property is regularly valued, and adequate scheme records are kept.

The board of a Responsible Entity must consist of at least half external directors otherwise the Law requires the scheme to have a Compliance Committee. The Compliance Committee must consist of at least three members, the majority of which are "external". Its role consists of monitoring the extent to which the Responsible Entity complies with the scheme's Constitution, the Law and the scheme's Compliance Plan, reporting any breaches of the Law or the scheme's Constitution to the Responsible Entity and, where the Responsible Entity does not take appropriate action to deal with such a matter, to report the matter to the ASIC.

### **MIS – Conclusion**

These requirements impose high standards on MIS REs to act in an honest, prudent manner, focus on issues of risk management. These requirements as well as the common law fiduciary duties owned by a trustee to beneficiaries (which apply to all MISs which are trusts) are in our view more than adequate grounds for Treasury to accept self certification by Managed Investment Trusts (a sub-class of MISs) of the reasons why they currently cannot make the Subdivision 230-E TOFA hedging election.

Given the existing definition of MIT in the ITAA 1997 and its adequate coverage of our members funds, we propose that this exemption apply MITs rather than to MISs. This will ensure adequate coverage of the exemption and will avoid complicating the tax law with multiple definitions covering the same type of entity.

### **Low Risk Status**

We also note that complying superannuation funds and MITs are currently recognised by the Federal Government in the tax laws as being low risk taxpayers. This low risk status should also be recognised in the current TOFA context.

This low risk status is reflected in a number of concessions afforded to these taxpayers including:

- The Division 275 CGT election for Managed Investment Trusts;
- The proposed new tax regime for the Managed Investment Trusts due to commence 1 July 2011;
- The former section 519B ITAA 1936 exemption from FIF for complying superannuation entities; and
- The proposed exemption from the rewritten CFC rules and proposed Foreign Accumulation Fund rules for complying superannuation entities.

## Question 2

### **What methods do fund managers propose to use to allocate FX gains and losses to the underlying assets to give rise to a reasonable attribution under Subdivision 230-E**

As a result of the hedging election under Subdivision 230 E election it is possible to defer recognising gains or losses on derivative financial arrangements such as foreign currency hedges. The method for determining the period over which such gains and losses are to be allocated must accord with the requirements of section 230 – 360.

Section 230 – 360 requires that the method:

1. Must fairly and reasonably correspond with the basis on which gains or losses on the hedged item are recognised;
2. Must be precise and detailed; and
3. Be objective.

For FX hedges taken out over a portfolio of foreign assets it is considerably more difficult to determine such a method than where the hedging is, say, in respect of one or two specific assets or liabilities. For institutional investors such as MITs and superannuation funds the situation is particularly problematic because the rates of realisation will vary from year to year. Additionally often such investors will take out FX hedges at a portfolio level and hence it is harder to identify what assets the particular hedge covers.

Sometimes managers will be able to take out cross currency swaps which closely match the investment period. So for example they will swap US\$ of AU\$ in three years time. As such instruments do not mature until the prescribed term expires, three years in the previous example, then the issue of allocating a gain or loss typically is less difficult. However, often FX hedging is undertaken by entering into short term FX forwards typically with a duration of 90 days. A series of such forwards across multiple currencies becomes very difficult to allocate. Additionally sometimes a forward over one currency is used as a proxy for another currency where there is a high degree of correlation. So, for example, a manager may not take out forwards in respect of its Mexican investments. Instead it will take out increased US\$ forwards as a substitute. What proportion of the US\$ forwards should be allocated against realisation of Mexican assets?

The FSC suggests that there are three possible methods of allocating FX hedging profits and losses where the hedged assets are within a portfolio.

- a. It is possible that a manager may have a sophisticated IT system that allocates the hedging profit to particular realised assets. If this is the case then the use of that system should be acceptable for the purposes of the Act. However, the difficulty of designing such software should not be underestimated. E.g. two stocks may comprise 1.5 and 1.6% of a portfolio on a given day. Some days later the share prices have moved and they now represent 1.7 and 1.5% respectively. From this it can be seen that the allocation of the hedge will vary from day to day entirely due to extraneous factors.

- b. In the first year of the hedging election the manager needs to determine a representative turnover rate for assets of the portfolio. This rate would be documented and would apply henceforth to all hedging outcomes, gains and losses. The rate would not vary from year to year but would need to be reassessed if significant change in investment philosophy or arrangement were to occur. An example of how this would work is shown in the attachment.
- c. The ATO / Treasury would issue a list of accepted rates for particular asset classes. Managers could elect to use the relevant rate for a portfolio. Having elected to use such a rate then that rate would be used for all following years. If the fund chose to alter its asset allocations materially then it would be possible to revisit the rate. The attachment showing how method B would operate is equally applicable to this example except that the turnover rate would accord with the Government list.

Example of method B.

A manager has a portfolio of global securities across 20 countries worth approximately AU\$100 Million. The investment mandate is that the portfolio be fully hedged into Australian dollars. The manager has determined that the portfolio is turned over every four years. In year one the manager makes a profit on forward contracts of \$12 Million. In year two the manager makes a profit on forwards on \$2 Million. In year three the manager makes a loss of \$ 8 Million and in year 4 a loss is made of \$2 Million.

FX profit / (loss) recognised from	Year 1	Year 2	Year 3	Year 4
Year 1	3	3	3	3
Year 2		0.5	0.5	0.5
Year 3			-2	-2
Year 4				-0.5
Total FX hedging recognised	3	3.5	1.5	1.0

## APPENDIX 1 - REGULATORY REGIME APPLYING TO SUPERANNUATION FUNDS

Australia's regulatory system for superannuation is globally acknowledged as being one of the best if not the best in the world. The system involves two primary regulators, the Australian Prudential Regulatory Authority (**APRA**) and the Australian Securities and Investments Commission (**ASIC**).

APRA licenses the superannuation trustee and regulates the governance and operation of the superannuation fund under the *Superannuation Industry (Supervision) Act 1933 (SIS)*, while ASIC regulates the market conduct and investor protection aspects for investors under the *Corporations Act 2001*. The following describes main features of the matrix of regulatory protections exist for superannuation investors.

### SIS section 52 – Governing rules:

1. *Superannuation fund trust deeds (governing rules) must be approved;*
2. *The governing rules are taken by section 52 of SIS to contain covenants that the trustee must:*
  - (a) act honestly in all matters concerning the entity;
  - (b) exercise in all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide;
  - (c) ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries; and
  - (d) keep the money and other assets of the entity separate from any money and assets, respectively:
    - (i) that are held by the trustee personally; or
    - (ii) that are money or assets, as the case may be, of a standard employer-sponsor, or an associate of a standard employer-sponsor, of the entity;
  - (e) not to enter into any contract, or do anything else, that would prevent the trustee from properly performing or exercising its functions and powers;
  - (f) formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:
    - (i) the management of investment risk having regard to its objectives and its expected cash flow requirements;
    - (ii) the composition of the entity's investments as a whole including risks from inadequate diversification;
    - (iii) the liquidity of the entity's investments having regard to its expected cash flow requirements;
    - (iv) the ability of the entity to discharge its existing and prospective liabilities;
    - (g) if there are any reserves of the entity--to formulate and to give effect to a strategy for their prudential management, consistent with the entity's investment strategy and its capacity to discharge its liabilities as and when they fall due; and
    - (h) to allow a beneficiary access to any information or documents required by the law.

### *SIS section 29E - Conditions imposed on all licences*

4. The trustee of a public offer superannuation fund must be licensed as a Registrable Superannuation Entity (RSE);
5. The duties of a trustee in respect of each registrable superannuation entity of which it is an RSE licensee must be properly performed by:
  - (i) if the RSE licensee is a body corporate--the body corporate; or

- (ii) if the RSE licensee is a group of individual trustees--each of the members of the group;
- 6. The RSE licensee must have a risk management strategy (section 29H) that complies with the law and sets out to apply to identify, monitor and manage risks that arise:
  - (i) in relation to its activities, or proposed activities, as an RSE licensee; and
  - (ii) in relation to all its other activities, or proposed activities, to the extent that they are relevant to its activities, or proposed activities, as an RSE licensee.
- 7. A risk management strategy must set out reasonable measures and procedures that a body corporate or group of individual trustees is to apply to identify, monitor and manage:
  - (i) the risks associated with governance and decision-making processes;
  - (ii) the risks that arise as a result of entering into outsourcing arrangements (other than arrangements that relate only to a particular registrable superannuation entity);
  - (iii) the risks arising from any changes to the RSE licensee law; and
  - (iv) the risks of potential fraud and theft.
- 8. An RSE licensee must:
  - (i) ensure that at all times its risk management strategy is up to date;
  - (ii) ensure that its risk management strategy is reviewed at least once each year to ensure that it complies with section 29H; and
  - (iii) modify, or replace, its risk management strategy in accordance with section 29HB if at any time the RSE licensee becomes aware that the risk management strategy no longer complies with section 29H.
- 9. The circumstances in which an audit of the risks referred to in this section is to be undertaken.
- 10. The RSE licensee must have a risk management plan that complies with the law. The risk management plan must set out reasonable measures and procedures that the RSE licensee of the entity is to apply to identify, monitor and manage the risks that arise in operating the entity including:
  - (i) the risks to the investment strategy relevant to the entity; and
  - (ii) the risks to the entity's financial position; and
  - (iii) the risks from entering into outsourcing arrangements relating to the RSE.
- 11. The RSE licensee must ensure that each registrable superannuation entity of which it is an RSE licensee has an Australian Business Number; and
- 12. Where the RSE licensee is a constitutional corporation it must meet capital requirements that satisfy section 29DA.

Under the Corporations Act the trustee of a superannuation fund that carries on a financial services business must hold an Australian Financial Services Licence. Those conditions include requirements for professional indemnity insurance and membership of an external dispute resolution scheme.

Offers of interests in a public offer superannuation fund must comply with the product disclosure requirements of the Corporations Act. Those requirements also provide provisions for the compensation of investors as a result of false or misleading information.

## **APPENDIX 2 – REGULATORY REGIME APPLYING TO MANAGED INVESTMENT SCHEMES**

### **Corporations Act: Chapter 5C Managed Investment Schemes**

#### *Section 601FC (1) – Duties of a Responsible Entity*

This provision outlines a series of duties owed by a Responsible Entity in exercising its powers. Among other obligations, the Responsible Entity must act honestly and in the best interests of the members. If there is a conflict between the members' interests and its own interests, it must give priority to the members' interests.

#### *Sec 601FD (1) – Duty of Officers of Responsible Entity*

Similarly, officers of a Responsible Entity must also act honestly and in the best interests of the members. If there is a conflict between the members' interests and the officer's own interests, they must give priority to the members' interests. Officers must also not make improper use of their position to gain, directly or indirectly, an advantage for themselves or for any other person or to cause detriment to the members of the scheme.

#### *Sec 601FE (1) – Duties of Employees of Responsible Entities*

An employee of a Responsible Entity must not make improper use of their position as an employee to gain, directly or indirectly, an advantage for themselves or for any other person or to cause detriment to the members of the scheme

#### *Sec 601FF (1) – Surveillance Checks by ASIC*

ASIC can check whether the Responsible Entity of a Registered Scheme is complying with the Scheme's Constitution and Compliance Plan and with the Corporations Act.

#### *Sec 601MA (1) – Civil Liability of Responsible Entity to Members*

A member of a registered scheme who suffers loss or damage because of conduct of the Responsible Entity that contravenes a provision of Chapter 5C of the Corporations Act may recover the amount of this loss or damage by action against the Responsible Entity whether or not the Responsible Entity has been convicted of an offence in respect of the contravention.

### **Corporations Act: Chapter 7 Financial Services and Markets**

#### *Section 911C – Prohibition on Holding Out*

A person must not hold out that they have an Australian financial services license or that a financial service provided by the person or by someone else is exempt from the requirement to hold an Australian financial services license if that is not the case.

#### *Section 912A – General Licensee obligations*

A Licensee must do all things necessary to ensure that financial services are provided efficiently, honestly and fairly.

Additionally, it must have in place adequate arrangements for the management of conflicts of interest, take reasonable steps to ensure that its representatives comply with the financial services laws and ensure that its representatives are adequately trained, and are competent, to provide those financial services.

#### *Section 912B – Compensation arrangements if financial services provided to persons as retail clients*

If a licensee provides a financial service to retail clients, the Licensee must have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations under Chapter 7 by the Licensee or its representatives.

#### *Section 912D – Obligation to notify ASIC of certain matters*

If a Licensee significantly breaches, or is likely to significantly breach, a financial services law, they must notify ASIC in writing within 5 business days after becoming aware of the breach or likely breach.

#### *Section 912E – Surveillance checks by ASIC*

A Licensee and its representatives must give such assistance to ASIC as ASIC reasonably requests in relation to whether the Licensee and its representatives are complying with the financial services laws, and in relation to the performance of ASIC's other functions.

#### *Section 915C – Suspension or cancellation after offering a hearing*

ASIC has the power to suspend or cancel an Australian financial services license where, among other matters, the Licensee has not complied with their obligations or ASIC has reason to believe they will not comply or where the application for the license contained a material omission.

#### *Division 6 – Liability of financial services licensees for representatives*

Licensees are responsible for the conduct of their representatives.

#### *Section 920A – ASIC's power to make a banning order*

ASIC may make a banning order against a person where, among other matters, they have not complied with financial services laws or have been convicted of fraud. A banning order is a written order that prohibits a person from providing a financial service or product.

#### *Section 1019B – Cooling-Off Period for return of Financial Product*

Retail clients have the right to return a financial product and to have the money they paid to acquire the product repaid within 14 days of having acquired the product.

#### *Section 1041G – Dishonest Conduct*

Prohibits a person from engaging in dishonest conduct in relation to a financial product or service.

#### *Section 1041H – Misleading or Deceptive Conduct*

Prohibits a person from engaging in conduct that is misleading or deceptive or likely to mislead or deceive in relation to a financial product or service.

### **ASIC Act 2001**

#### *Section 12 CC – Unconscionable Conduct*

Prohibits unconscionable conduct in the supply or acquisition of financial services. In ascertaining whether the conduct was unconscionable, Courts may have regard to matters including:

- a) the relative strengths of the bargaining positions of supplier and service recipient;
- b) ability of recipient to understand the related documents;
- c) undue pressure or unfair tactics;
- d) circumstances under which the service recipient could have acquired similar/ identical services from a different supplier; and
- e) the extent to which the supplier and service provider acted in good faith.

*Section 12DA – Misleading or Deceptive Conduct*

Prohibits conduct that is misleading or deceptive or likely to mislead or deceive in relation to financial services.

*Section 12 DB – False or Misleading Representations*

Prohibits the making of false or misleading representations with respect to the standard, quality, value, price, affiliation or need for financial services.

*Section 12ED - Warranties in relation to the supply of financial services*

It is an offence to supply financial services without taking due care and skill.