Australia as a Financial Centre

Seven years on

The Second Johnson Report

June 2016

INTRODUCTION by Mark Johnson

In November 2009 the Australian Financial Centre Forum released the Government-commissioned Report, *Australia as a Financial Centre*. The Report noted that Australia has arguably the most efficient and competitive full service financial sector in the Asia-Pacific region. It is strong, well-regulated and highly regarded around the world.

"Yet our exports and imports of financial services are low by international standards," stated the report, which became known as the Johnson Report due to my chairmanship. "Our funds management sector, one of the largest and most sophisticated in the world, manages only a small volume of funds sourced from offshore."

The Report identified several barriers to increased financial services exports and made a range of policy recommendations on how they could be overcome.

Since the Report was issued, some progress has been made in exporting our expertise in funds management. Investment by foreign fund managers into Australian Managed Investment Trusts (MITs) has doubled from $20.3 billion to $43.6 billion over the past five years, but the proportion of total exports represented by financial exports has remained static at 3.6 per cent over that period. There is potential to export a lot more.

The Report outlined an interrelated package of proposals designed to help achieve this: the Asia Region Funds Passport, a new range of collective investment vehicles, and an Investment Manager regime. Pleasingly, these recommendations have been progressed through the efforts of the Federal Government, Treasury, the Australian Securities and Investments Commission and the Australian Taxation Office. Once these changes have been fully implemented, it will be up to fund managers to start taking full advantage of the enormous opportunities in Asia. It is only then that the benefits will become fully apparent and Australian managers can start developing the capabilities that are being sought by Asian investors. Full realisation of the economic benefits of the policy changes will take some time.

Some large Australian fund managers are already managing overseas sourced funds, but mostly doing so in offshore jurisdictions. This limits the benefits to Australia because much of the potential employment and tax revenue remains offshore. Encouraging Australian fund managers to build up global expertise in Australia remains a sensible policy objective but it will take ongoing policy changes as both financial markets and overseas policy settings continue to evolve.

Assessing where Australian policy settings have got to and what more is currently needed is the focus of this follow-up report.

Forum members – Paul Binsted, Alf Capito, Patricia Cross, Jeremy Duffield, Craig Dunn and John Story and the Forum secretariat of Geoff Weir and John Larum – and I identified what was at stake when we handed down our report in 2009: "The opportunities for leveraging off our financial services skills and expertise, in the region and beyond, are potentially enormous."

This is as true today as it was then.

Mark Johnson

The Benefits And The Barriers

Six years after the release of the Johnson Report, the time has come to measure how much progress has been made on its recommendations, with a focus on funds management. This stocktake highlights the barriers which remain and catalogues new barriers which have emerged or become apparent since the report was issued, based on a survey of fund managers undertaken by the Financial Services Council.

Fund managers nominated several barriers which are still causing them difficulties and identified several additional barriers, particularly in the areas of tax and licencing.

Removal of these barriers will help the Australian funds management sector increase its exports of financial services, unlocking the benefits to the broader Australian economy which were outlined in the Johnson Report.

These include improving Australia's growth prospects and standard of living; increasing skilled job opportunities within the financial sector and attracting talented and experienced expatriates back to Australia; and reducing the cost of financial products and the cost of capital.

These benefits are as significant today as they were in 2009. A report by Deloitte Access Economics and the Financial Services Council in 2014 found that if Australia could grow overseas-sourced funds under management to be equal to that of Hong Kong over the next decade the benefits would be even greater. GDP would grow by over $4.2 billion, tax revenue would increase by $1.2 billion and nearly 10,000 jobs would be created.

Australia is well situated to take advantage of these opportunities. We are located in the fastest growing region in the world. For many countries in the region, growth in income and wealth, along with demographic factors, will increasingly require development of a wider range of financial services, including capital markets to help finance development, retirement income schemes, and asset management and insurance products to provide for wealth management and its protection. This is likely to require, over time, a further opening up of regional financial markets to innovation and competition from new entrants.

Summary of Johnson Recommendations and Current Status

The following table provides a summary of the recommendations from the Johnson report and their current status.

RECOMMENDATION	STATUS
Introduction of Investment Manager Exemption	Legislated June 2015
Support for offshore banking units	Commenced, but modernisation not achieved
Review allowing a broader range of collective investment vehicles	Commitment, not yet implemented
Development of an Asia Region Funds Passport	Commitment, not yet implemented
Removal of withholding tax for foreign raised funds and foreign banks	Not implemented
Remove impediments to Islamic finance	Commitment, not yet implemented
Removal of state taxes and levies on insurance	Not implemented, situation worsened
Road-testing of all significant financial services regulatory proposals to ensure necessity, effectiveness and to minimise compliance burden	Not implemented
Periodic reviews of regulatory rules and framework to prevent against overregulation	Commenced, one review held
Government to more actively promote Australia as a financial services centre	Commenced
Establishment of a Financial Centre Taskforce	Commenced, recommendations largely ignored, eventually disbanded

THE JOHNSON RECOMMENDATIONS IN DETAIL

INTRODUCTION OF INVESTMENT MANAGER EXEMPTION

STATUS: LEGISLATED JUNE 2015

In June 2015, Parliament established an investment manager regime (IMR) in Australia to provide greater clarity and certainty regarding the tax treatment of offshore transactions undertaken through Australia.

These changes were made in response to concerns raised in the Johnson Report that industry uncertainties about how cross-border transactions would be taxed in Australia were driving potential financial transactions, investment flows and new business opportunities away from Australia.

The uncertainties arose when foreign-sourced funds were invested into offshore assets via an Australian-managed vehicle. Although the intention had never been to tax these investments, complexities in Australian tax and trusts law meant sometimes they could be taxed.

Using an Australian manager raised considerable uncertainty about how the location of an organisation, where decisions are made, where it earns its money, and whether those earnings were revenue or capital gains would affect its tax treatment. This worked against having important decisions about a financial entity's offshore funds management or asset allocation policies being made in Australia.

This in turn was discouraging international financial services companies looking to establish regional headquarters, or parts of their regional operations, in Australia.

The IMR addresses these concerns by clarifying the rules so that foreign-sourced incomes and gains made on behalf of offshore investors using Australian managers are not taxable.

A second issue the IMR clarified was how income and gains on Australian assets held by offshore investors should be taxed. It stated that investments in Australian assets would, for tax purposes, be treated the same as if the investments were made directly by the non-resident without the use of any Australian intermediary. It means that investors' gains or losses are taxed in the same way as they would be if the investor held them as a direct investment rather than through an Australian or foreign fund manager.

The IMR brings Australia into line with other offshore financial centres which already have investment manager exemptions in place, including Hong Kong, Singapore, New York, Tokyo and London.

One fund manager said that previously if a foreign institutional investor had wanted to buy assets in Australia using an Australian manager, it might have preferred to do so via an entity in another jurisdiction such as Singapore even though the Australian manager might have been making the decisions on assets allocation. This meant a loss from Australia of the employment associated with establishing and maintaining the fund as well as the ensuing tax revenue.

The IMR is one of the critical reforms needed for Australian-based funds to be marketed into Asia and fund managers said the reforms have been effective. Senior members of the Australian Taxation Office understand that Australia's reputation for "taxation uncertainty" can do great harm to the growth of the financial services sector and the IMR exemption is a big step toward repairing this reputation. However, the full benefits of the IMR will only be realised when the other complementary recommendations from the Johnson Report are implemented.

SUPPORT FOR OFFSHORE BANKING UNITS

STATUS: COMMENCED, BUT MODERNISATION NOT ACHIEVED

The Offshore Banking Unit (OBU) regime aims to encourage offshore financial transactions between non-residents to be conducted by an Australian institution, rather than by an offshore financial institution.

An OBU is subject to a concessional tax rate of 10 per cent for eligible offshore activities and an exemption from interest withholding tax.

However, certain features of the OBU regime rendered OBUs much less effective than they were intended to be. In fact at the time the Johnson Report was written, many of the registered OBUs were not active.

Firstly, there was considerable uncertainty among existing OBU users relating to the issue of whether industry has a 'choice' as to whether all OBU-eligible activities have to be treated as OBU transactions. Many said that without the ability to choose whether to book transactions to the OBU or the domestic account, the OBU regime would be unworkable.

Secondly, the list and descriptions of eligible OBU activities in the tax legislation had not been updated since 1999 and had become out of date and unclear. Many potential and actual OBU licensees feel they were trying to fit 'square pegs in round holes'.

OBU licensees or potential licensees were concerned the ATO would heavily penalise any inadvertent transgression of the boundaries between what can be transacted through an OBU and what cannot.

The Johnson Report recommended the two issues outlined above be rectified.

Reforms to the OBU regime became applicable from 1 July 2015 and include codifying the 'choice principle' to remove uncertainty for taxpayers and modernising the list of eligible OBU activities. However modernisation of the regime to enhance Australia's financial service export has not been achieved and a broadening of its application is still not complete.

ALLOWING A BROADER RANGE OF COLLECTIVE INVESTMENT VEHICLES

STATUS: COMMITMENT, NOT YET IMPLEMENTED

In the May 2016 Budget, the government committed to introduce two new collective investment vehicles (CIVs) from 2017 that will put Australian fund managers on a level playing field with fund managers from other countries and allow them to make the most out of the new passport regime.

The new CIVs will allow fund managers to offer the sorts of collective investment vehicles that many international investors prefer and are familiar with, and to make better use of the Asia Region Funds Passport.

A corporate CIV is expected to be operational from 1 July 2017. It is likely to be an attractive vehicle for retail and wholesale investors. A limited partnership vehicle will follow from 1 July 2018 which is expected to be targeted mainly at wholesale investors.

Until now Australian fund managers have been operating at a disadvantage when compared with managers from other leading funds management centres such as the United Kingdom.

Fund managers and their international clients require an investment vehicle that provides a flow-through of any tax liabilities from the vehicle to the end investor. They also need it to meet other investor protection and commercial needs. Until the most recent commitment, Australia's tax and securities laws in effect limited the range of commercial vehicles that can be used to manage funds to the unit trust structure, which is unfamiliar to Asia-Pacific investors who did not come from common law jurisdictions.

The only other alternative for Australian-based funds was to use collective investment vehicles that are established and administered offshore, such as in Luxembourg, Dublin or the Cayman Islands, and in some cases also base their fund managers offshore. This was expensive, time consuming and not in Australia's interests.

There is also additional complexity and uncertainty with respect to the extent to which funds structured as unit trusts can benefit under some of Australia's double tax treaties.

In order to better facilitate Australian fund managers managing assets for non-resident investors, consideration needs to be given to these factors when designing the new collective investment vehicles.

New legislation will be introduced over the next 12 months, and these details will determine how successful the new regime will be.

Whatever the ultimate shape of the collective investment vehicles, it is important that there be a mechanism to update them and recognise new structures as they emerge. Currently, any changes need to be legislated via changes to the Corporations Act. This can create delays of several years, with the risk that

Australian fund managers won't be able to keep up with changing market dynamics and needs in the same way their competitors are able to.

There are two possible solutions. One would be for Parliament to introduce a principles-based regime, where investment structures are approved as long as they adhere to certain legal principles. A second approach could be to devolve this power to the relevant Minister or to the Australian Securities and Investments Commission.

DEVELOPMENT OF AN ASIA REGION FUNDS PASSPORT

STATUS: COMMITMENT, NOT YET IMPLEMENTED

The Asia Region Funds Passport (ARFP) was recommended in the Johnson Report as a way to improve market access for ARFP countries to each other's markets and as a key element in Australia's ability to compete as a regional financial services centre.

The ARFP is making good progress following years of hard work and negotiation by Treasury and ASIC. On 28 April this year Australia, Japan, Korea and New Zealand signed a Memorandum of Cooperation to implement the regime in 2018. Thailand is also expected to sign and Singapore is considering joining.

The ARFP will allow collective investment products offered in one ARFP economy to be sold to investors in another economy. Currently, funds are manufactured, distributed and administered within each jurisdiction, with little transferability across borders.

The ARFP regime will carry several benefits for Australia. For Australian-based fund managers looking to sell their products offshore, improved market access will provide opportunities for lower costs through increased scale. Australian fund managers will also be able to build up greater regional expertise, which they may then be able to export outside the region.

The ARFP could also provide significant cost benefits in terms of reducing duplication. Currently, a fund manager marketing the same fund in different jurisdictions is required to have a fund in each jurisdiction.

These benefits will have flow-on consequences to the wider Australian economy, including lower fees, increased employment of Australian fund managers, fund administrators and support staff, and increased tax revenue for the government.

To commence, the ARFP regime will need to be implemented in each individual jurisdiction. Once two jurisdictions have adopted the new rules, the regime becomes live, with other countries joining as they in turn implement the rules.

There are already several competing passport regimes, including the European Union's UCITS regime, the ASEAN Collective Investment Scheme (ASEAN CIS) and a mutual recognition regime between Hong Kong and mainland China which permits Hong Kong or Chinese mainland managed funds to be bought and sold in each other's jurisdiction.

The EU's UCITS regime has made significant inroads into Asia with funds domiciled in Luxembourg or Dublin being distributed from Hong Kong, Singapore or Taiwan.

Local fund managers suggested that one of the reasons for the popularity of UCITS within Asia is that its rules are well documented and well understood, and so give investors confidence. The ARFP will have similar rules, also laid out in a clear and unambiguous fashion.

However, investors and fund managers who issue products will need to be persuaded to switch to using the ARFP over the other passport regimes and in particular UCITS. Some fund managers have suggested that the ARFP should offer investment managers more flexibility, such as a wider range of allowable investments. Concerns among some managers regarding the direction of regulatory changes in the UCITS regime potentially create an opportunity for a competing passport regime that is tailored for the Asian market.

Such a regime would facilitate the creation and sale of product by ARFP countries into each other's jurisdictions. While this would initially be most appealing to locally headquartered funds managers, in time global fund managers might also come to see benefits of using the ARFP if it is sufficiently cost effective and flexible, and incorporates more countries in the region.

REMOVAL OF WITHHOLDING TAX FOR FOREIGN RAISED FUNDS AND FOREIGN BANKS

STATUS: NOT IMPLEMENTED

Since the Johnson Report was written it has become increasingly apparent that Australia's overall investment tax regime and its complexities are a deterrent to financial services exports. This will be covered in more detail in the next section of this report.

However, the Johnson Report identified interest withholding tax on most forms of offshore borrowing by financial institutions as a specific tax which is problematic and not in Australia's interests, and it remains a problem.

Australia is a capital importing country and so needs access at commercial rates to a diverse range of offshore savings pools to finance domestic investment needs. However, unlike many other financial centres, Australia levies interest withholding tax on most forms of offshore borrowing by financial institutions.

This has raised the cost of capital for Australian banks borrowing offshore, and hence for Australian businesses and households that borrow from banks. This is because, in order to raise funds offshore, Australian banks have to be prepared to pay non-resident lenders after-tax rates of return on their investments that are at least as high as the rates of return that those lenders can earn on investments in other countries.

In addition, several exemptions to the application of the tax have resulted in significant competitive distortions and inconsistencies.

As a result, Australian banks do not access offshore retail and wholesale deposits nearly as widely or as cheaply as they could. This reflects the fact that the burden of interest withholding tax is ultimately borne by the borrower.

The withholding tax also affects foreign bank branches and subsidiaries, and can lead a foreign bank to decide against doing some business through its intermediary in Australia.

The Johnson Report recommended removing withholding taxes on interest paid on foreign-raised funding by Australian banks; on interest paid to foreign banks by their Australian branches; and on financial institutions' related party borrowing.

There have been no further announcements regarding this tax.

REMOVAL OF REGULATORY BARRIERS TO ISLAMIC FINANCIAL PRODUCTS

STATUS: COMMITMENT, NOT YET IMPLEMENTED

The Middle East is a major source of offshore capital and there appears to be an opportunity for Australia in terms of accessing offshore capital pools at competitive rates in the area of developing Sharia-compliant wholesale investment products.

The global market for Islamic financial services has boomed to an estimated US$2 trillion in 2014.

Islamic financial products are structured to make them compliant with Sharia Law provisions such as those which prohibit speculation or the payment or receipt of interest. But this can create regulatory and tax consequences.

For example, certain types of Islamic products often have multiple investors and take forms that could potentially bring them within the definition of a managed investment scheme or other regulated entity under the Corporations Act 2001, with a range of substantial legal consequences.

In the taxation sphere, there are issues about the eligibility for withholding tax relief on widely distributed Sukuk bonds and the possibility that capital gains tax could inappropriately apply to the disposal or transfer of assets. At the State level, there is potential for stamp duties to be inappropriately applied to those transfers.

The Johnson Report recommended the removal of any regulatory barriers to the development of Islamic financial products in Australia, guided by the principle that there should be a 'level playing field' for such products.

The Johnson Report also recommended that the Treasurer refer to the Board of Taxation the question of whether any amendments to existing Commonwealth taxation provisions are necessary in order to ensure that Islamic finance products have parity of treatment with conventional products, having regard to their economic substance.

This work was undertaken by the Board of Taxation in 2011, but the report was not released until 3 May 2016.

In the May 2016 Budget, the government committed to remove key barriers to the use of asset backed financing arrangements which are supported by assets, such as deferred payment arrangements and hire purchase arrangements, and to clarify the tax treatment of asset backed financing arrangements and ensure that they are treated in the same way as financing arrangements based on interest bearing loans or investments. The changes are intended to apply from 1 July 2018.

REMOVAL OF STATE TAXES AND LEVIES ON INSURANCE

STATUS: NOT IMPLEMENTED, SITUATION WORSENED

Insurance policies, unlike most other financial services, are subject to various State indirect taxes and levies, such as stamp duty, Insurance Protection Tax and fire service levies, and there is no consistency in the application of these imposts across the States. Insurance providers often need processes and procedures specific to each State.

These State taxes add significantly to the cost of insurance, especially for those businesses operating at a national level, and are undoubtedly a factor contributing to underinsurance, with consequent increased demands on the public purse.

The Johnson Report recommended that all State taxes and levies on the insurance sector be removed.

This has not been implemented.

The Johnson Report also noted that these taxes were a significant source of revenue for the States (in 2013-14 total State and Territory taxes on insurance were $5.66 billion) and said such reform would likely only take place as part of a much broader tax review.

ROAD-TESTING SIGNIFICANT FINANCIAL SERVICES REGULATORY PROPOSALS

STATUS: NOT IMPLEMENTED

Australia's regulatory system and the quality of senior regulatory staff are one of the strengths of our financial system. However, care needs to be taken to ensure that any new regulations are clearly necessary in Australia's circumstances and are implemented efficiently and effectively, avoiding undue costs to the corporate sector.

Our robust regulatory system and the way in which it was administered through the global financial crisis were important factors in allowing our financial system to emerge from the crisis in relatively good shape.

The global financial crisis also brought about a push for more regulation of financial systems around the world and there were concerns this could ultimately result in Australia adopting additional regulatory layers and requirements which are neither necessary nor relevant to our circumstances.

The Australian Government does have some mechanisms in place to prevent unnecessary regulation, such as the requirement that regulatory proposals which might impose a significant regulatory burden or compliance cost be accompanied by a Regulation Impact Statement (RIS). But perceived inadequacies in this and other similar evaluation processes reinforce the importance of consulting wherever possible with the financial services industry on proposed regulatory changes.

The Johnson Report recommended that any significant regulatory proposals applying to the financial services sector be fully tested and evaluated, in particular and wherever possible by way of detailed industry consultation, to ensure that they are necessary, effective and impose as small a compliance burden on industry as possible.

This has not been implemented.

PERIODIC REVIEW OF REGULATORY RULES AND FRAMEWORK

STATUS: COMMENCED, ONE REVIEW CONDUCTED

Over time an excessive amount of regulation of financial services builds up that needs to be periodically reviewed.

In some ways this is the result of a largely one-sided incentive system facing governments and regulators: incentives are heavily skewed towards not missing anything, rather than removing unnecessary regulations.

Hence periodic reviews and reassessments of the regulatory framework to ensure it remains best practice have clear merit. Indeed, it is arguable that one of the reasons we have a very good regulatory framework is that it has been the subject of periodic review in recent decades, such as the Australian Financial System Inquiry in 1981 and the Wallis Inquiry in 1997.

Australia's regulatory system is an important area of comparative advantage, particularly in the wake of the global financial crisis; periodic reviews are vital to ensuring it remains so. Reviews need to take account emerging domestic and global developments in financial systems, and the capacity of Australia's regulatory framework to accommodate those developments.

The Johnson Report recommended there be periodic reviews of the regulatory rules and framework applying to the financial sector to ensure that excessive and unnecessary regulatory rules and requirements do not build up and that Australia's regulatory rules and framework remain best practice in the face of changing circumstances, products and market practices.

Since the Johnson Report, the Government commissioned the 2014 Financial System Inquiry chaired by David Murray, which noted that that improved regulatory processes could reduce industry costs and lead to better outcomes. That inquiry recommended governments and regulators adhere to minimum implementation lead times and monitor impacts more thoroughly post-implementation.

GOVERNMENT NEEDS TO MORE ACTIVELY PROMOTE AUSTRALIA AS A FINANCIAL SERVICES CENTRE

STATUS: COMMENCED

Recent and prospective policy changes designed to help develop Australia as a financial centre need to be complemented by actions to raise Australia's profile in the region, increase familiarity with, and confidence in, our regulatory framework, and showcase our capabilities.

Such promotional activity should also emphasise the mutual advantages to countries in the region from closer engagement in each other's financial markets.

Many countries in the region are looking to develop their private capital markets; improve their corporate governance practices and regulatory systems; develop pension and insurance systems; and diversify the range of assets in which their pension schemes are invested away from just government bonds and bank deposits.

In all these areas, Australia can contribute to the development of financial markets in the region and benefit over time from such engagement.

The Johnson Report recommended the Australian Government make a declaration of its intent to maintain and improve the openness, competitiveness and regional engagement of Australia's financial sector, including within the broader context of greater regional integration and cooperation.

This is underway.

ESTABLISHMENT OF A FINANCIAL CENTRE TASK FORCE

STATUS: COMMENCED, THEN DISBANDED

The Johnson Report recommended the establishment of a Financial Centre Task Force charged with maintaining a close dialogue between the financial sector on the one hand, and Treasury and the Government on the other, on all policy issues of relevance to the Government's objective of developing Australia as a leading financial services centre.

The Task Force was to help ensure that new policy measures were effectively implemented; monitor policy developments in overseas financial centres; and provide advice about future policy measures that may be necessary in the light of evolving domestic and international developments, including reviews or updates of existing policies.

It would also monitor any relevant changes in taxation legislation or in tax administration in overseas financial centres, with a view to identifying any measures which it considered worthy of possible adoption in Australia and make recommendations in other areas where it sees a case for a review of existing tax legislation.

The Task Force was to report to the relevant Minister every six months.

In late 2010 the former Government announced it would establish the Task Force and appoint Mark Johnson as Chair. However, the Task Force's recommendations were largely ignored and it was eventually disbanded in mid-2013.

The need for this Task Force is even stronger today than it was at the time of the original recommendation. Major overseas developments in financial services continue to emerge yet there is no monitoring body to assess them, or Australia's progress as a leading financial services centre.

NEW BARRIERS

WITHHOLDING TAX

Australia has a complex and high withholding tax regime for foreign investors.

Fund managers identified Australia's overall withholding tax regime as a significant impediment to attracting funds from foreign investors, beyond those specific instances identified in the Johnson Report.

Different rates of withholding tax apply depending on the character of the income received by the investors. There are individual rates of withholding tax for dividends, interest and royalties in addition to withholding tax on certain fund payments from Managed Investment Trusts. The rate for each is determined by the type of income, country, tax treaty or exchange of information agreement.

Furthermore, the headline rates of withholding taxes are higher than in many other jurisdictions.

These high and complex tax rates limit the attractiveness of Australian funds for foreigners and will limit any benefits Australia might derive from the Asia Region Funds Passport (ARFP). The current state of Australia's withholding tax rates will not be marketable in the competitive environment that the ARFP seeks to create.

The ARFP is focussed on retail clients. If it is to deliver its full potential benefits, it will be necessary for foreign investors located in other participating jurisdictions to receive simple and clear tax advice regarding the consequences of investing in an Australian passport fund. This is not possible in the current environment.

Further, for Australia to compete effectively it will be necessary to better align the withholding tax regime with the comparable withholding tax rates charged by other jurisdictions.

Under Australia's current withholding tax arrangements, there will be other more attractive destinations in Asia from which to operate a passported fund and Australia risks losing the competitive advantage it has in funds management.

In fact, tax overall is a major issue in foreign investors' minds, fund managers have commented.

Australia is perceived to have an inefficient and complex tax regime. Perceptions are sometimes worse than the reality, but concerns about the taxation of Australian-based funds are nonetheless a deterrent for Asian investors engaging Australian managers. For instance, one fund manager said that while tax leakages are less than they were five years ago, many Asian investors believe they are still significant.

These impediments make it much harder for fund managers to compete with vehicles for a tax neutral jurisdiction. "You are on the back foot immediately, when you start to compete with those," said one manager.

TREATMENT OF FOREIGN EXCHANGE GAINS AND LOSSES

When Australian-based fund managers invest their clients' funds in overseas assets, they buy foreign exchange derivatives to hedge against foreign currency movements that would affect their holdings.

However, under the Australian tax system, profits and losses on these derivatives are treated as assessable income or losses, even when the asset they relate to continues to be held.

The issue is that the tax position of such investments diverges from the true economic position of the asset. For instance, a 90 day foreign exchange forward relating to a parcel of foreign shares might show a gain when it expires, even though the shares it relates to could be have made an unrealised loss. Those gains would have to be distributed to fund investors, who in turn would have to pay tax on them, even though the underlying shares were in a loss making position.

This problem could be overcome if the rules were clarified and if taxpayers were able to opt into the clarified treatment or not.

The Government has already demonstrated it is not averse to such an approach. Under the Taxation of Financial Arrangements rules, it is possible to make a hedging election such that the profits and losses on derivatives are matched against the underlying assets and brought to account at the same time, and in the same manner, that these assets are realised.

In the 2016/17 Budget the Government committed to make changes however these have not been implemented.

MULTI-CURRENCY CLASS INVESTMENT FUNDS

Different foreign investors have different needs when putting money into a foreign fund. Some want to invest in their own currency, while others want to invest in a different currency; some want hedged investments, others don't.

Asian investors are concerned about the perceived volatility of the Australian dollar and so have a strong preference to invest in US dollars. The ability to offer US dollar-denominated products more easily will help put Australian fund managers on more of a level playing field with funds from other jurisdictions.

Fund managers want to offer offshore investors a range of different investment options through a single collective investment vehicle, rather than incurring higher costs from establishing multiple vehicles to achieve the same outcome.

To achieve this Australia requires collective investment vehicles which allow multiple currency classes. In a true multi-currency class vehicle, gains and losses relating to one class do not affect another class of interests within the same fund.

Laws introduced in May 2016 to establish a new taxation regime for Managed Investment Trusts attempted to address this issue for trust vehicles but the changes have not solved the problem entirely. The new rules permit an election to treat each class as a separate trust for tax purposes and will allow quarantining of gains and losses within a class, however the effectiveness of these provisions relies on associated changes being made to the treatment of foreign currency gains and losses (see Treatment of Foreign Exchange Gains and Losses, above).

Fully functioning multi-currency class capability must also be available to any new collective investment vehicles that are developed, in particular the proposed new corporate collective investment vehicle.

Allowing true multi-currency class functionality across all collective investment vehicles will better position Australian fund managers to take advantage of the Asia Region Funds Passport and the recent North Asian free trade agreements.

THE RESPONSIBLE ENTITY MODEL

Under uniquely Australian corporate law provisions relating to the funds management industry, the same entity can be both the trustee of a fund and the investment manager.

Known as the single Responsible Entity model, the provision is unique among common law jurisdictions, where the roles of trustee and investment manager are usually carried out by separate entities. In those jurisdictions the fund manager mainly only provides investment management services and outsources the other duties.

Fund managers said the fact that in Australia these roles can be undertaken by the same entity is confusing and concerning for some Asian investors. For instance, if a product issuer is also the valuer of the units relating to the product, then there is an apparent conflict of interest. While there are regulations and practices that mitigate against this conflict in Australia, there is still the perception of a conflict of interest.

This is a problem which could be solved either through the introduction of a new collective investment vehicle with different governance provisions or with the adoption of the international standards over time.

RECOGNITION OF THE AUSTRALIAN FINANCIAL SERVICES LICENCE BY OFFSHORE JURISDICTIONS

As important as the Asia Region Funds Passport is, it will focus on the ability of funds to attract offshore retail investors. To attract the larger and potentially more lucrative institutional investment funds, further changes would be required, including the recognition of Australian Financial Services Licence (AFSL) holders in other jurisdictions.

This would take the form of an exemption from local licencing requirements, in the same way that Australian regulators provide an exemption for the holders of some foreign financial services licence holders to operate in Australia without an AFSL under ASIC Regulatory Guide 176.

This would pave the way for Australian fund managers to issue and manage institutional investment products in foreign jurisdictions. This is important because most funds need access to institutional investments to reach a commercially viable scale.

There is currently provision for mutual recognition of financial services licences in the free trade agreements that Australia has recently negotiated with China, Japan and Korea. However, before these provisions can take practical effect, regulators in the relevant countries also need to recognise each other's financial services licences.

Australia also recognises the financial services licences of funds from several foreign jurisdictions, but often this is not reciprocated for Australian funds.

UNCAPPED LIABILITY ON CAPITAL FOR PRODUCT ISSUER

Under ASIC regulations, Responsible Entities (product issuers) that hold scheme assets are required to hold net tangible assets of the greater of $10 million or 10% of their revenue.

This requirement is uncapped, so that as a fund grows it is required to hold more capital. This provision is unique in global investment regulations and fund managers says it makes Australian funds less competitive than those which don't have uncapped capital requirements.

One fund manager commented that once a fund reaches around A$10 billion in funds under management it becomes uncompetitive with funds issued in other jurisdictions, such as Luxembourg or Singapore. This is another reason why it is often more effective for Australian fund managers seeking investors from Asia to set up their funds in other jurisdictions, with the loss of the tax revenue and employment to Australia.

A cap of up to A$20 million in liabilities for product issuers would solve this problem. Other jurisdictions also allow funds to hold professional indemnity insurance for some of the required amount.

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