29 March 2023

Committee Secretary
House of Representatives Standing Committee on Economics
PO Box 6021
Parliament House
Canberra ACT 2600

Inquiry into promoting economic dynamism, competition and business formation

The Financial Services Council (**FSC**) welcomes the opportunity to provide a submission to this inquiry.

About the FSC

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services. Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advice licensees.

Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses. The financial services industry is responsible for investing more than $3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pools of managed funds in the world.

Background

It has been a long standing, bi-partisan ambition for Australia to become a financial services centre.[1] Australia has a high skilled funds management industry with low fees by global standards – Australia has the equal best rating for fees and expenses in the Morningstar Global Investor Experience Report.[2] The industry's growth has been underpinned by the growth in domestic superannuation investment, with $4.3 trillion in funds under management, up from $3.83 trillion in June 2020.

However, Australia's full potential as a dynamic and competitive international exporter of financial services is currently unrealised. The proportion of funds under management sourced from overseas investors is only 6.5%[3], compared to Singapore where 78% of funds under management is sourced overseas.[4] In Luxembourg the proportion is about 95%,[5] and in Ireland it is about 90%.[6]

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[1] Australian Financial Centre Forum Australia as a Financial Centre, Building on our Strengths, November 2009, known as the Johnson Report
[2] See: https://www.morningstar.com/lp/global-fund-investor-experience
[3] Australian Bureau of Statistics, *Managed Funds, Australia, September 2022*, Tables 1 and 9
[4] Monetary Authority of Singapore (MAS), *Singapore Asset Management Survey*, 2021, p2 and *Singapore Asset Management Survey*, 2011, p1
[5] Over 95% of assets in Luxembourg funds come from other countries: https://www.cssf.lu/en/2023/02/origin-of-uci-initiators-in-luxembourg/ See also: https://www.cssf.lu/en/2023/03/investment-fund-managers/
[6] See: https://www.centralbank.ie/statistics/data-and-analysis/other-financial-sector-statistics/investment-funds

Financial Services Council Ltd
Level 5, 16 Spring Street
Sydney NSW 2000
E. info@fsc.org.au
W. fsc.org.au
ABN 82 080 744 163
@FinServCouncil
@FinServCouncil
@financial-services-council

The FSC recommends that the Committee investigate the regulatory barriers that prevent the Asia-Regional Funds Passport (**the Passport**) and the Corporate Collective Investment Vehicle (**CCIV**) from being fully utilised and how the removal of those barriers can boost economic dynamism and competition in the funds management industry.

In summary, the FSC submits the Committee should consider recommendations to address:

- Australia's complicated and uncompetitive tax settings for (potential) Passport funds;
- the issue of a lack of track record of appropriate Australian fund vehicles;
- a lack of clarity of the tax settings for investors that use Passport funds;
- restrictions on eligible funds/assets in the Passport; and
- the lack of harmonised disclosure requirements across the Passport.

Asia Regional Funds Passport

The FSC is a strong supporter of the Asia Regional Funds Passport. If the regulatory settings are right, the regime would lead to an increase in exports of Australia's significant funds management expertise, increasing employment in the industry, Government revenue and economic growth.

There are also benefits for consumers with reduced costs and an increased ability to diversify across the regime. An APEC study[5] estimated that an effective fund passport regime could mean:

- A reduction in expenses in the funds management industry of around 20 basis points across Asia, leading to lower fees and hence higher retirement savings for investors.
- An increase in employment in Asia – estimated to be 170,000 jobs in Asia as funds domiciled outside of Asia are brought back to Asia.
- Investors can build portfolios with higher return for a given volatility (that is, a higher Sharpe ratio).

The Asia Regional Funds Passport was legislated in 2018, with the then Government estimating that there would be $14 billion in Passport funds by 2028.[7] This now seems unlikely given the substantial and ongoing regulatory barriers preventing adoption of the Passport. The potential gains listed above are not being realised and potential gains for consumers and industry are being lost. Adoption of the Passport by funds has been disappointing with no Australian funds having joined the Passport as of time of writing. If regulatory barriers are not addressed, we anticipate that this situation will continue.

Global fund managers currently use investment vehicles domiciled outside the Passport and market these vehicles into the Passport region, even though these non-passport funds might be eligible to use Passport fund rules. The Passport should make it easy to distribute funds in the Passport countries, but global managers are consciously avoiding the Passport demonstrating the need for improvements to the architecture of the Passport.

We invite the Committee to consider how Australia can ensure that it does not miss out on the opportunity presented by the Passport. We submit the following issues for the Committee's consideration.

[7] Corporations Amendment (Asia Region Funds Passport) Bill 2018 – Revised Explanatory Memorandum.

Taxation barriers for the Passport

The complexity of Australia's withholding tax settings are a key barrier to the adoption of the Passport. Investors overseas have the perception that Australian funds are subject to high rates of tax. The reality is that there are various exemptions and special rates which means that the actual withholding tax raised from funds is small. However, the complexity means this is difficult to explain to overseas investors, who have the impression that they would need to pay a high tax rate.

For example, investors may be advised that they could be subject to:

- withholding tax of 30 per cent on an unfranked dividend, even though this would only occur for a small part of most portfolios (if at all), while franked dividends are not subject to withholding tax; and
- withholding tax of 15 per cent on interest, but it is not clearly understood that exemptions reduce this to zero in most (but not all) cases.

In addition, Australian funds are subject to unpredictable (and unwarranted) withholding tax that further discourage the use of Australian funds, for example Australian tax can be imposed on:

- non-existent 'gains' caused by the incorrect tax treatment of foreign exchange hedging;
- gains on the sale of bonds that should be eligible for the interest withholding tax exemption but are not; and
- posted collateral (noting there is an exemption for posted collateral in many other jurisdictions).

Because these settings are complex, arbitrary and unforecastable, investors simply avoid the uncertainty of investing in Australian funds when other competitor jurisdictions have simpler and lower tax settings that appear more attractive. This leads to the situation of zero adoption of the Passport in Australia and no revenue raised from Passport fund.

There is simply no way to explain the above tax issues (and other related tax problems) in a way that would encourage non-Australian investors to invest through Australian funds, particularly when Singapore and other competitor jurisdictions have much simpler and lower tax settings that work to attract non-local investors by providing certainty to investors.

As a result, Australia has a lose-lose situation – a tax system that significantly impedes investment due to its complexity while delivering little revenue.

Relevantly, a study by PwC for a Passport industry day in 2018 showed that an investor into an Australian fund in certain (limited) circumstances would pay similar tax in an Australian fund as in a Singaporean or Japanese fund, but the complexity of explaining this was clear, with PwC noting:[8]

> *…there is also a degree of misunderstanding about investor tax outcomes that invites less informed conclusions to be drawn on the tax outcomes to investors….The asset categories [in the PwC analysis] are at this stage consistent with the classes permitted under the ARFP. If the tables [showing the tax outcomes] were extended to cover more countries and include domestic concessions and Double Tax Agreements, the analysis becomes very complicated. It may therefore not be feasible to seek to perfectly harmonise tax outcomes to investors.*

[8] PwC

The FSC **recommends** that:

1. The complex variety of withholding tax rates for managed funds be replaced with a single low rate of 5 per cent applying to all payments made by Passport funds, other than income that is already exempt and income from Australian real property.
2. The tax rules that inappropriately apply withholding tax on payments, particularly on foreign exchange hedging and gains on sale of bonds, be reformed.

The revenue impact of recommendation 1 is likely to be minimal, as Passport funds are required to be simple products, which means:

- Dividend income is likely to be franked, qualify for lower withholding rates due to tax treaties, or qualify for an exemption as conduit foreign income.
- Interest income will likely to be substantially exempt (under section128F) or overseas sourced and therefore exempt.
- Capital gains, apart from property, would generally be exempt due to the withholding tax exemption for Australian assets that are not taxable Australian real property.

Any tax on remaining income could be inappropriately applied as a result of foreign exchange hedging and gains on sale of bonds (as noted above) and should not have been imposed regardless.

In relation to recommendation 2 above, the FSC notes that the reform of foreign exchange hedging is an announced but unenacted measure most recently reaffirmed in the October 2022 Budget.

Corporate Collective Investment Vehicle

The FSC is strongly supportive of the Corporate Collective Investment Vehicle (CCIV). The CCIV is a new type of Australian investment vehicle which utilises the corporate structure, rather than a trust structure. This structure is familiar to other jurisdictions, particularly those in the Passport, where it is common to have a corporate structure and flow-through tax status.

The CCIV regime has only recently commenced operation in Australia. We are aware of several licenses that have been granted to be a corporate director of a CCIV, and several license applications are in progress. Further, several global investment management houses are actively considering the merits of converting to use this vehicle.

The key barriers we have heard to the adoption of the CCIV include the time taken to develop a track record for a new fund, the lack of a regime to facilitate the transition of existing funds into the CCIV, the seed capital required, and the complexity and costs involved of maintaining existing trust structures alongside the new CCIV.

Taken together this means Australia effectively still does not have an investment vehicle with a track record that can be used with the Passport. This is important because ratings agencies and distributors such as financial advisers and investment platforms will be unwilling to recommend an investment product without a track record.

As noted above, an important barrier to the adoption of the CCIV is the time taken to develop a track record for a new fund. We understand many distributors will seek an investment performance record of three years before they will recommend an investment product. Given this, the earliest an Australian CCIV could be recommended would be the end of 2025, and potentially later.

Most of these issues could be addressed by adopting the FSC's recommendation for a comprehensive rollover regime to facilitate the transition of existing funds into a CCIV.

The FSC **recommends** the creation of a comprehensive transition regime to facilitate the conversion of existing funds into the CCIV structure. This regime should:

- Ensure the conversion of an existing fund into a CCIV sub-fund is not a taxing point.
- Simplify the process for maintaining consumer protection relating to the rollover.
- Be available for all types of existing funds, including Managed Investment Trusts (MITs), Attribution MITs (AMITs) and Listed Investment Companies (LICs).

Further details on the FSC's recommended approach to a CCIV transitional/rollover regime are contained in previous FSC submissions on the CCIV:

- FSC submissions to CCIV Tax and Regulatory framework – January 2019 exposure drafts.[9]
- FSC submission to Senate Inquiry into Corporate Collective Investment Vehicle Framework and Other Measures Bill 2021.[10]

The FSC's submission to the Senate Inquiry cited above also raises concerns that the CCIV tax rules effectively 'deem' a CCIV sub-fund to be a trust for tax purposes. This creates a number of problems – a key benefit of the CCIV was that it moved away from trust tax rules, but the existing rules re-create the very problem the CCIV was meant to remove. The FSC submits the tax rules could be amended fairly easily with no risk to tax revenue as highlighted in the submissions above. In addition, the FSC's submission to the Senate Inquiry highlighted other improvements that could be made to remove ambiguities in the operation of the CCIV.

Restrictions on Passport holdings

Fund managers have also noted that the restrictions on the use of financial arrangements by Passport funds are an important disincentive to use the Passport.

The restrictions, including on the use of illiquid assets and derivatives, can potentially mean a Passport fund:

- has a limited ability to invest in property, infrastructure, private equity, venture capital, and alternative assets.
- is restricted in the ability to use 'feeder' funds where an investment fund is one of several sub funds (referred to as feeder funds) that pool their investment capital into an overarching umbrella fund, known as the master fund, to invest.
- may be unable to have a substantial holding of one financial arrangement, even if that asset is highly liquid and low risk.
- has a restricted ability to use derivatives to implement changes in asset exposures, a technique that can be used by funds that are not classified as hedge funds under ASIC rules (RG 240).

[9] This submission is in two parts. The non-tax issues are in this submission: https://fsc.org.au/resources/1718-fsc-submission-cciv-draft-2019-01-regulatory/file
The tax issues are in this submission: https://fsc.org.au/resources/1719-fsc-submission-cciv-draft-2019-01-tax/file
[10] See: https://fsc.org.au/resources/2385-fsc-submission-senate-inquiry-into-cciv-and-retirement-income-covenant-bill/file

- For example, equity funds commonly make use of equity derivatives for efficient portfolio management, even simple long-only equities funds. Derivative usage can be essential for cash flow management and is an important part of best practice management.

We understand that the combination of the restrictions above means that many existing funds would be ineligible to become Passport funds, even funds that are seen as diversified, highly liquid, and/or low risk. We understand that other similar passporting regimes, such as UCITS in Europe, do not apply such restrictions on the use of financial arrangements.

The current restrictions mean there are very limited numbers of Australian investment funds that could become Passport funds. Distributors are keen to distribute existing products throughout the region but are unable to do so using the current framework; and issuers are unlikely to create specific products just to comply with the Passport rules.

The commercial success of the Passport depends heavily on the ability of distributors to provide investment products to customers that are different from existing products available in the home jurisdictions.

The FSC therefore **recommends** that Treasury and ASIC work with Passport jurisdictions to implement a substantial relaxation of the rules that restrict the use of financial arrangements by Passport funds, with a focus on ensuring that many common or typical funds used in Passport jurisdictions are able to become Passport funds.

Disclosure

FSC members have also noted that a streamlined approach to disclosure would improve efficiencies and support for the Passport. One specific suggestion was that a fund operating in the Passport should be able to prepare one disclosure document and then simply have it translated into the other operating Passport languages with minimal or no changes. This would be similar to the approach used for UCITS funds in Europe. This would result in an important cost reduction compared with the requirement for different documents need to be prepared in each jurisdiction to meet each of the different regulatory requirements.

The FSC **recommends** that the Passport jurisdictions review the disclosure requirements for Passport funds, with a view to simplifying and harmonising so there is one common requirement across all Passport jurisdictions.

Clarity of tax treatment of Passport funds

FSC members have raised concerns about the tax treatment of investors using Passport funds - particularly for Passport funds that are being distributed cross border where there may be less familiarity with tax rules. There is significant cost and work for distributors to undertake the detailed analysis required to provide certainty both to distributors and to potential investors.

Therefore the FSC **recommends** that Passport jurisdictions should create a forum of industry with tax authorities to develop consistent and simple advice on how investors into Passport funds are taxed.

This would ensure that all parties have greater clarity of tax rules and any concerns these rules may raise.

Conclusion

The FSC is keen for the Passport and the CCIV to meet their intended goals. The FSC considers the changes recommended above will go a long way towards promoting the Passport and the CCIV, and support the export of Australian funds expertise.

Yours sincerely

Signed

Spiro Premetis
Executive Director, Policy and Advocacy