FSC FINANCIAL SERVICES COUNCIL

Advanced Manufacturing, Services and Technology and Investor Visas
Australian Trade and Investment Commission (AUSTRADE)
Level 23
201 Kent Street
SYDNEY NSW 2000

7 August 2017

Sent via email to: investorvisas@austrade.gov.au

Dear AUSTRADE Review Officer,

RE: Complying Investment Framework Consultation Paper

Thank you for the opportunity to submit our views on the 'Complying Investment Framework' (CIF) consultation paper.

The Financial Services Council (FSC) has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

We are concerned that the scope of the CIF review will not allow us full opportunity to discuss our views with respect to the framework. It appears that the previous announcements on this topic merely concluded that the '… *enhanced CIF is working well*' without, in our view, concrete review or rationale. We appreciate the opportunity to submit our views and would appreciate a direct discussion to further discuss the points raised in our submission.

The present nature of the CIF means that we have reputable Australian funds management businesses which have been effectively excluded from participating in the Significant Investor Visa (SIV) program for no solid reason. It is our view that this is not an optimal outcome for both the SIV program, as well as the Australian economy. Additionally, the current position is contrary to the Government's broadly ascribed principles of open and fair competition. At the very least, the assets permitted under the CIF should at least be 'competitively neutral', and not favour any one asset class over another.

The Government has previously confirmed that the purpose of the SIV is to 'boost the Australian economy through increased inflow of investment'. Amongst other concerns, at present fund types/structures which appropriately provide capital for the small business/start-up sector are excluded under the current - and, by extension future-state - CIF.

We also hold the view that without appropriate changes being made to its structure, the CIF essentially favours certain asset classes over others. We firmly believe that the assets permitted under the CIF should at least be 'competitively neutral' and not direct investment resources to some asset classes at the expense of others, for seemingly no sound economic or financial reason.

Instead, we argue that it would be preferable for the definition of a CIF to be more open ended and not restrict investment choice. This is a high-level stance that has strong policy precedent already, as the Government has openly supported such an approach in the superannuation sector definitions for SIV. The statistics on visa applications show a dramatic fall in applications, hence providing less investment into the Australian economy. This alone is good grounds to review the Complying Investment Framework, backed up by the points above.

At a high level, the FSC requests the Government to:

1. Remove specific limit amounts/percentages in each fund type – allow flexibility
2. Retain ability to invest in venture capital (VC) and microcap funds (Australian small companies) but do not mandate how much
3. Reinstate credit/mortgage funds as an eligible fund
4. Reinstate bond and cash funds as eligible funds, and
5. Include Exchange Traded Funds (ETFs) as an eligible investment

Our detailed discussion of these critical broader policy concerns can be found below in 'Annexure A', plus our responses to the questions posed by this current review of the CIF can be found in 'Annexure B'. Finally, in 'Annexure C' we address key miscellaneous 'downstream' concerns that may arise following changes to the CIF/SIV framework.

Should you wish to discuss the FSCs submission further, please contact me directly on 02 8235 2514, or via cchivers@fsc.org.au

Thankyou for your consideration of these important matters.

Yours sincerely

Catherine Chivers
Policy Manager
Investments & Global Markets
Financial Services Council

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ANNEXURE A – COMPLYING INVESTMENT FRAMEWORK FOR THE SIGNIFICANT INVESTOR VISA - POLICY CONCERNS AND RECOMMENDATIONS

The FSC recommends that the current Complying Investment Framework ('CIF'') be reviewed and broadened to encourage increased investment in Australian managed funds generally, including bond funds plus mortgage funds governed by ASIC Regulatory Guide 45 and exchange traded funds (ETFs) in order to minimise economic distortions produced by limiting CIF choice.

Simply put, the current investment allocation specifications of the program are not efficient for the market or investors.

Specifically we recommend the removal of the specific % limits and types of funds permitted within the CIF, and include additional fund types which may better meet the reduced risk appetite for more risk-averse individuals, such as: mortgage funds, bond funds and cash funds. This will achieve the twin-goals of significantly increasing the appeal of the Significant Investor Visa (SIV) program, as well as further investment into the Australian market as a whole, whilst avoiding unwanted 'distortions' within the market.

We also would welcome the SIV Balancing Investment option to be allowed to invest in Initial Public Offerings (IPOs) as a way of broadening and also deepening the permitted asset pool for program participants.

As an aside, we note there appears to be misperceptions held broadly within Government surrounding the benefits and overall positive economic contribution of the bond market to the Australian economy, as well as the general structure of mortgage-based funds (as well as misunderstanding surrounding their broader economic benefits). It is our concern that such misperceptions have adversely impacted the inclusion of such investments within the CIF framework as an unintended consequence. We address these concerns briefly below.

Reason 1 - Avoids economic 'distortions' which arise with limiting CIF choice

Government-directed investments into specific markets have been examined by previous Financial System Inquiries. These inquiries have shown that directed investments do not result in competitive returns for investors, undermining economic returns and distorting the market.

The Campbell Inquiry in 1981 and the Wallis Inquiry in 1996 both looked at mandating asset allocation, including the 30/20 rule under which 30 per cent of life and superannuation assets were effectively required to be invested in public sector securities, of which two-thirds were mandated to Commonwealth securities. The 30/20 rule was abolished in 1984 after the Campbell Inquiry found that directed investment was ineffective, inefficient and distorted the financial system. Ian Chalmers[1] stated in a 1995 Parliamentary Research Report: it is "*difficult to escape the conclusion that directed investment must involve reduced returns...*" for investors.

[1] Consultant to the Economics, Commerce and Industrial Relations Group of the Parliamentary Research Services.

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Reason 2 - Bond funds do make an economic contribution to Australia

Bonds held in managed funds make an economic contribution to Australia through taxation, manager and placement fees and increased employment.

The FSC does not believe that there is a basis for the following comments made by the Hon. Andrew Robb, former Minister for Trade and Investment:

> *…the money going into low-risk bonds makes no real contribution to Australia's economic growth. "If (the funds) are going to government bonds, which could be sold anytime and anywhere at a good price, Australia is getting nothing out of it," Mr Robb told The Australian. "They just park money there for four years and got citizenship. It does not make a lot of sense to me from a public policy point view."*[2]

There is evidence however, that contrary to the above, bond funds do in fact make a valuable economic contribution to Australia. Each $5 million contributed via the SIV contributes just short of $300,000 (on average), or 6% of the total visa investment amount, to the Australian economy in taxation and fund manager fees. This is calculated as follows.

Average economic contribution on $5m invested in bond fund:

1. **Tax:** 15% if MIT. Assume earnings at average annual yield **=** $5m * 5.78% * 4 years *15% tax = $173,400 tax paid over 4 year period per SIV**.** (Refer table below for how the 'average annual yield' was determined)

2. **Fund manager fee** – median MER for AU equities fund = 0.58%[3] * $5m * 4 years = $116,000

3. **Placement and handling fee (one-off entry fee) on managed fund investment =** nil, typically spread only

4. **Employment** – qualitative figure. Refer to Research by Deloitte Access Economics for the FSC which found that if Australia could grow overseas-sourced funds under management equal to that of Hong Kong over the next decade, our GDP would grow by more than $4.2 billion, tax revenue would increase by $1.2 billion and nearly 10,000 jobs would be created.

5. **Trustee and custodian fees, accounting and audit fees –** specific data on this aspect is not immediately referable, however, it is clear from point 4 (above) that such investments provide additional broad support to the Australian financial services industry, and by logical extension, employment.

Average Australian economic contribution based on $5m investment
= $173,400 + $116,000
= $289,400, over four year period

Calculating the 'average annual yield' for an Australian Bond Fund

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[2] The Australian, 23 October 2014

[3] Median MER for AU domiciled fixed income fund per FSC-Morningstar Australian Managed Funds Industry report = 0.58%. http://www.fsc.org.au/downloads/file/PublicationsFile/2016_FSCMorningstar_AustnManagedFundsIndustryReport.pdf

Fund	Three-year total returns as at 30 June 2017 (%)
Vanguard Australian Fixed Interest Index Fund (Wholesale)	4.31
UBS Australian Bond Fund	4.00
AMP Capital Corporate Bond Fund	3.21
Nikko AM Australian Bond Fund	4.06
PIMCO Australian Bond Fund	4.29
AVERAGE	**3.98%**

Source: Fund Manager's own performance data obtained from their respective websites

Reason 3 –Mortgage funds contribute positively towards Australian capital markets and the broader liquidity pool

Mortgage (credit) funds are a recognised and long-standing part of the funds management and finance industries in Australia. They are not merely investments in real estate or mortgages, as their namesake may otherwise suggest.

Within the Australian capital market, mortgage (credit) funds serve two key roles:

1. For borrowers: a source of finance, particularly for borrowers underserviced by banks, and
2. For investors: represent a capital stable, income producing investment, which is suitable for investors with conservative risk appetites, as well as those who may prefer to have a stable income-producing element to a portion of their overall investment portfolio (irrespective of how conservative – or not – their risk appetite is).

These funds can be structured on a 'pooled' or a 'contributory' or 'peer to peer' basis. Both structures serve the two roles outlined above. The key difference between such structures is that a 'pooled' scheme pools investors' funds and invests in a range of loans. This pooling typically necessitates the holding of incidental cash/term deposit funds. By contrast, the 'contributory' or 'peer to peer' schemes involve investors choosing the individual loans in which they wish to invest.

In either case, the interest payments by the borrower generate the returns to investors net of management fees.

It is a common and understandable misconception that mortgage (credit) funds invest in mortgages. This is fundamentally incorrect. Instead, mortgage (credit) funds invest in loans to borrowers. The mortgage itself is purely the security pledged by the borrower in return for obtaining a loan of this nature.

How do mortgage funds contribute to the economy?

Mortgage (credit) funds contribute directly to the economy as they allow businesses and individuals to access capital via such loans, which can then be used for a variety of income-producing purposes (but most typically, financing business expansion), which then allows the capital to flow through to the broader economy.

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Typically, the lending business of a mortgage (credit) fund fills gaps left by the traditional banking sector by providing niche loan products. Most commonly, the borrowers of a mortgage (credit) fund are the self-employed and small business people, who are not well served by banks and other financial institutions. These small businesses and individuals who may be unable to obtain capital via traditional means are now able to inject capital to grow their business enterprises. In these circumstances, the borrower can be required to pledge security (often commercial or residential real estate, depending on the borrower's circumstances) as security for the loan – which is a position no different to the credit provision requirements of the traditional banking sector.

As has been widely documented, the small business sector in Australia has been poorly served by most traditional financial institutions and most small-to-medium enterprises face significant challenges in accessing capital at reasonable interest rates, so as to feed and grow their businesses. This issue has been acute, in particular, since the GFC, with business credit growth persistently soft and many traditional lenders explicitly limiting their exposure to the sector in a variety of ways, but especially through strictly enforced high credit standards.

This lack of access to capital is a significant headwind for small-to-medium business, and by logical extension, a serious impediment to job creation. This is a significant economy-wide issue for Australia, given that the small business sector accounts for almost half of private sector industry employment, rising to almost 75% when combined with medium business.

Reducing SIV flows to the mortgage (credit) fund sector will have the effect of reducing finance options for the self-employed and small businesses. This will have a negative impact on economic growth and job creation.

Regulation of mortgage funds

With mortgage (credit) funds being an 'unlisted' investment (that is, not traded on any recognised securities exchange), there may be the misperception that such funds are 'opaque' in nature, and thus lack any meaningful oversight from regulators.

In reality, this is not the case – as all mortgage (credit) funds are heavily regulated by ASIC in that:

1. They require a specific ASIC licence to operate
2. ASIC Regulatory Guide 45 provides specific guidance on addressing key fund governance matters such as:
    - Liquidity
    - Scheme borrowing
    - Loan portfolio and diversification
    - Related party transactions
    - Valuation policy
    - Lending principles—Loan-to-valuation ratios
    - Distribution practices, and
    - Withdrawal arrangements

Finally, we recognise the sensitivities around mortgage (credit) funds having connotations around residential real estate, but as we've already outlined, in no way do these funds provide a 'back door' to owning Australian real property (either directly or indirectly). Instead, these funds are an excellent example of those that directly help small Australian businesses who otherwise could not obtain capital and is therefore in complete alignment with the broader spirit of the SIV program.

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Reason 4 - Exchange traded funds are an attractive and growing product set for investors

Exchange Traded Funds (ETFs) invest in a large range of Australian companies on the ASX.
An ETF is a collective investment vehicle whereby interests in that vehicle (usually known as 'units') can be traded on a securities exchange. ETFs are one of the fastest growing investment products in the world, offering investors a simple and cost-effective way to achieve diversification in their investment portfolios. ETFs offer efficient, low-cost diversification, combined with flexibility and liquidity. ETFs can be bought and sold on a stock exchange like shares. And, like managed funds, they contain a diversified portfolio of securities designed to track specific indices. This means investors can use ETFs to gain the exposure and diversification they want, quickly and simply.

It is also important to highlight that all ETF units traded on an exchange (i.e. secondary market) would have originated in the primary market. Therefore, all ETF units created generate investment in the Australian economy in the same way as units created in a managed fund generate investment in the Australian economy.

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Annexure B – Responses to specific questions comprising the CIF review

1. **Should the VCPE component of the SIV CIF be increased from $500,000 to $1 million? Why or why not?**

A: The VCPE component of the SIV CIV should not be increased from $500,000 to $1 million for the following reasons.

We acknowledge that the government in formulating the changes to the rules applying to the SIV complying investment framework, which applies to applications submitted after 1 July 2015 ("new rules"), clearly noted an intention to consider an increase in the VCPE component from $500,000 to $1,000,000 within two years of introduction of the new rules "as the market responds". Whilst this proposal to consider an increase in the VCPE component is clearly understood by professional parties who deal with the complying investment framework on a day-to-day basis, we do not believe that such changes are likely to have been contemplated by SIV investors.

Indeed, investors currently undertaking the application process are not the same investors who were undertaking the application process at the time that the new rules were initially announced. Whilst these earlier investors may have been aware of a proposal to increase the VCPE component at a later date, it is our view that investors currently working their way through the application process would be doing so on the basis of the VCPE component being $500,000. Such investors are likely to perceive an increase in the VCPE component as a significant change to the SIV complying investment framework (representing a 100% increase in allocation to the riskiest component of the complying investment framework) and being a change that they were previously unaware of.

The proposed increase in the VCPE component to $1 million is likely to reduce the appeal of SIV investors to invest in Australia. This is due to the inclusion of mandatory investments in what we considered as relatively riskier asset classes such as VCPE and small cap or microcap funds.

Venture capital investment or venture capital funds are generally considered as high-risk investments. Investors (regardless of whether they are SIV investors or not) are often hesitant in putting their money in start-up companies (in the form of venture capital investments). Venture capital investments are also regarded as illiquid (i.e. venture capital funds are generally structured with an investment period of seven to ten years, with limits on how investors could exit the fund during the investment period). Consequently, the general illiquidity of the venture capital funds combined with an increase in demand for other asset classes could result in pricing distortions, such as an artificial inflation of the price of the venture capital investments as against other investment options.

The proposed increase could create a problem through the dynamics of supply and demand, if a mandated flow of capital (demand side) is deployed to unworthy venture capital investments offered by the industry (supply side), without proper consideration of the investment merits. This is different to the usual decision made by a non-SIV venture capital investor who would consider the venture capital investment's merits in detail before making a decision, particularly important given the high-risk nature of the asset class. Taking a top-down view, the increase in the VCPE component appears to be supportive to the venture capital sector, however, we believe it could actually prove to be detrimental to the sector. It could lead to the establishment of venture capital funds purely for the sake of catering to SIV investors, without the quality of investment management who are seasoned enough to manage this asset class.

Grants of visas under the new rules have, since the introduction of the new rules, co-existed with the grant of visas under the rules applying to applications received prior to 1 July 2015 ("old rules"). Whilst the grant of visas under the old rules, having regard to the monthly statistics provided by DIBP, now appear to be substantially winding down, it is unclear what the intended number of grants is expected to be under the new rules in a "steady state" environment.

This is important as the absolute size of additional capital flowing into the VCPE market will influence the impact that any increase in VCPE component will have on the overall VCPE market.
The VCPE segment is a small but important segment of the financing landscape that provides capital and commercialisation skills to early stage companies. In the Financial Year 2016, $568m was raised by Australian venture capital funds being the highest amount on record and substantially in excess of the long term average4.

In conclusion, we believe that the proposed increase in the VCPE component would discourage foreign investors to invest in Australia and could create the wrong behaviour on the supply side of the equation. Most SIV investors have limited market knowledge about the Australian venture capital industry and this is likely to be a deterrent in attracting foreign investors into Australia. Simpler investments that are more easily understood are better suited for foreign investors.

Potential Solutions:

1. The entire purpose of introducing VCPE and EC component in attracting SIV investors has been to direct investments in areas which can contribute positively to the Australian economy.

   We believe that instead of increasing the VCPE or EC component, the government should encourage investment in the following needed industries, which by definition align with the government's broader policy for the next 10 years:

   a. Infrastructure development, for example road, rail, energy. That is, if the government can play a management role of private public partnerships and can have its local treasury corporation act as custodians of SIV capital, we believe and advocate for a minimum % of capital put to work in such initiatives;

   b. "Social impact" and "Green" bonds, similar to those issues by certain Australian financial institutions in recent years. These have the powerful benefit of improving society as well as government finances; and

   c. Investment which contributes to Australians and the Australian economy in general.

   We believe that finding the right balance between attracting investment interest and directing investment into key areas will be critical to the success of attracting SIV investors.

2. We believe that mortgage (credit) funds plus government and semi-government bonds should be reintroduced as an investment option. We believe this is appropriate as government bonds can provide exposure to a defensive asset which may be a necessary balance from an overall portfolio management perspective. We believe the availability of such defensive assets is of

[4] Australian Private Equity & Venture Capital Association Limited - The Venture Capital Effect: A Report on the Industry's Impact on the Australian Economy. June 2016

increased importance given the introduction of a prescribed minimum investment in high risk assets. We also believe that government bonds provide a benefit to the economy by ensuring flow of capital and funding and can also assist in keeping prices on the secondary market low through increased liquidity, which may help to reduce the issuer's borrowing costs.

3. We suggest having a registration process for all SIV funds similar to the one followed for the registration of venture capital funds under the *Venture Capital Act 2002* (Cth). In this way, only those funds which are actually deemed to comply with the SIV regulations are registered and offered to SIV applicants. At present, every provider of SIV funds is claiming to be compliant, which might not be true in all cases.

a. What would be the likely impact on demand for the SIV if the VCPE component were increased?

A: We believe that, just as the introduction of the new rules saw a significant initial decrease in demand from investors applying for a significant investor visa, any changes to the VCPE component would also see a reduction in demand. This in turn may cause a negative impact on the Australian economy if the number of investments and money inflow were to decrease. We believe that this decrease in demand would be as a consequence of three main factors:

1. the change when considered in the context of the broader review of Australia's business, investment and talent visas and a potential range of changes to a suite of visa classes, would likely add to a perception of increased political risk in relation to Australia's visa regime
2. An increase in the amount required to be contributed to the VCPE component would result in an increased allocation to the riskiest element of the CIF thus increasing the overall risk profile of an investment in the SIV CIF, and
3. Under the SIV CIF, an investor is required to hold complying investments (assuming the investor does not apply to extend the visa under the extension scheme) for a period of 4 years. The average duration of an investment in a VCPE fund exceeds 4 years. By increasing the amount allocated to the VCPE component, the average duration of an investment under the SIV CIF will increase.

b. Is there sufficient absorptive capacity in the Australian venture capital market to manage this increase?

A: In our view, no. This is because the probability of success for a business that is in the process of proving its business case in start-up situations is low (which is why venture capital investments in small cap or microcap funds are considered high-risk for investors). In addition, the answer as to whether there is sufficient absorptive capacity in the Australian venture capital market is inextricably linked to the rate of steady state processing of grants under the new rules.

Since the introduction of the new rules, the rate of granting visas under the new rules has been significantly lower than the rate of applications received from potential investors, on a monthly basis. This has been due, at least in part, to the need to apply resources to the parallel processing of applications under the old at the same time as processing applications under the new rules.

In the year to date to 31 May 2017, 169 investors have been granted visas[5] resulting in total funding into the VCPE component of $84.5m. During the financial year 2016, $347m was invested by venture capital funds (being a 50% increase on financial year 2015) with $300m of this being invested by domestic funds[6]. On this basis, the VCPE component would have represented approximately 28% of funds invested by domestic funds during financial year 2016.

Accordingly, if it is intended that a steady state rate of processing grants would result in more visas being granted under the new rules than occurred during financial year 2017, it is important to consider this in light of any proposal to increase the VCPE component from $500,000 to $1,000,000.

Rather than risk flooding the market with additional capacity by increasing the VCPE component at the same time as reaching steady state processing of grants under the new rules, it would be preferable to stagger these two outcomes.

c. If the VCPE component increases to $1 million, should the emerging companies or balancing investment components reduce by $500,000 to compensate? Why or why not?

A: If the VCPE component were to increase to $1,000,000 then a reduction to either the emerging companies or balancing investment components would result in a change to the risk allocation to the investor. In either case, the risk assumed by the investor would be increased (albeit by a smaller amount in the case of the emerging companies component).

Such an increase in risk allocation is likely to have negative impacts upon investor demand, as noted above.

Similarly, an increase in the overall complying investment amount from $5 million to $5.5 million would increase the risk profile for the investor. In this case, however, the increased risk profile would result from an increased value at risk being invested into the most risky component. Such an increase in risk allocation is also likely to have negative impacts upon investor demand.

As for the balancing investments component, it is typically considered as the safety net for the investors. It is able to give the investors the flexibility to invest in diverse asset classes and choose safer investments in order to preserve their capital investments. As there is no fixed allocation, the investor has the flexibility to pick and choose investments as their need and risk appetite. As such, if the Government is of the view that the VCPE component must be increased; we would recommend that the balancing investment components should not be reduced by $500,000 to compensate.

2. Austrade is also seeking views on better aligning some specific SIV technical settings in the Legislative Instrument ('the Instrument') to the intent as set out in the CIF one-page summary (PDF). Specifically, Austrade invites comments on the following technical matters:

a. **Emerging companies as ultimate investees**: The SIV emerging company's component is intended to benefit small and emerging Australian companies. To provide further assurance that the ultimate beneficiaries of this component are small rather than large capitalised companies,

[5] DIBP Significant Investor Visa statistics https://www.border.gov.au/about/reports-publications/research-statistics/statistics/work-in-australia/significant-investor-visa-statistics (accessed 27/7/17)

[6] Australian Private Equity & Venture Capital Association Limited - The Venture Capital Effect: A Report on the Industry's Impact on the Australian Economy. June 2016

Austrade invites views on whether the Instrument should specify the emerging companies investment must not be made in securities that otherwise meet the requirements for this component but where the issuer of those securities invests the proceeds of the issue of those securities in securities that do not meet the market capitalisation requirements for the emerging companies component. For example, this would mean small exchange traded funds which invest in the securities of large capitalised companies would not be compliant with the requirements of the emerging companies investment component.

A: We agree the proposition that the SIV emerging companies component is intended to benefit small and emerging companies. As such, we would be supportive of amendments that sought to ensure that the SIV emerging companies component was invested as intended and was not indirectly invested in other asset classes.

Nonetheless, we urge for the unintended consequences to be considered, the risk of which is far greater than the perceived deficiency it attempts to address. This change could potentially cause any number of permitted investments to be deemed non-compliant due to changes in the issuer's balance sheet. This would all be done without the knowledge of the fund manager/responsible entity of an otherwise SIV compliant Managed Investment Fund. Please find as follows two clear examples of how the proposed changes to the Instrument would have unintended consequences if stricter protocols were introduced with a goal of ensuring emerging companies are the ultimate investees.

Company A - Market capitalisation $300m, quoted on ASX limited
Situation – (SIV compliant) Managed Investment Fund holds shares in Company A as a permitted investment for the emerging companies investment component.
Action - The board of Company A independently decides to invest surplus funds from a recent capital raising into Telstra Shares (ASX:TLS) to earn a higher return pending further investments.
Result - Company A is suddenly no longer a permitted investment as Company A invested in securities issued by a large capitalised company (Telstra), consequently the Managed Investment Fund is not a complying significant investment and all 188C Visa holders who invested in the Managed Investment Fund are at risk. Please consider that the fund manager of the Managed Investment fund would not know Company A bought Telstra shares, and may never know as Australian financial reporting standards may not require this level of detail to be disclosed.

REIT B Market cap $350m quoted on ASX limited
Situation – (SIV compliant) Managed Investment Fund holds units in REIT B as a permitted investment for the emerging companies' investment component
Action - The manager of REIT B independently decides to invest spare cash deposits into bonds (being debentures) for higher yield whilst awaiting a property settlement
Result - REIT B is suddenly no longer a permitted investment as REIT B invested in debentures, consequently the Managed Investment Fund is not a complying significant investment and all 188C Visa holders who invested in the Managed Investment Fund are at risk. Again the fund manager would not know that REIT B is no longer a permitted investment, and may never know as Australian financial reporting standards may not require this level of detail to be disclosed.

However, we believe that consideration is required in relation to the 30% cap on investment in previously held investee equities which now have a market capitalisation above $500m. This metric is

too simple and problematic and can force unnecessary company share price value volatility and destruction through investment managers needing to sell some investments when they hit the $500m market cap limit.

There is also no current bias as to the types of companies and sectors which receive the investment. There are some companies and industries which are less capable of managing such capital in the sub-$500m space and may not manage it as effectively as a company in the $500m-$1bn market cap space. So the $500m factor - whilst benefiting SIV compliance through being a clearly objective measurement – may have unintended consequences and may also not be the best method of achieving the Government's economic growth objectives. This is also at a time when many small growth oriented companies have a long number of years ahead of them in terms of building on such growth as they migrate through different phases of the mid-cap market structure, thus benefiting local employees and local shareholders through this value creation path.

We are also concerned about the requirement for a minimum of 20 investee companies from 3 months post the fund's inception date. The reason for this is that there could be: (a) a start-up small cap fund issued by an established firm and 20 investments may not be feasible; and (b) a specialist small cap manager that focuses on a particular industry/subset where 20 investee companies is unfeasible.

We believe it would be better for the Instrument to specify the types of sectors which should receive EC investment, in line with the Government's agenda to grow the 'economy of tomorrow'. These sectors might be aged care, healthcare, education, clean energy and advanced technologies, for example. The Instrument should specify a bias towards these sectors through a higher proportional weighting to companies in these sectors, with perhaps a zero weighting towards 'old industries'.

The market cap element should also be modified to avoid the forced sale of companies when they hit $500m market cap. The Instrument could perhaps require managers to gradually reduce their exposure to a company which has reached the $500m market cap level. This could potentially be through the use of tiered maximum exposure levels as the company's market cap reaches and surpasses the $500m level, for example maximum 5% of net assets at $500m, reducing to 0% as market cap continues to increase.

Another practical way to address this challenge is to lift the market cap limit from $500m to $1bn, which we favour. We firmly believe this benefits the local economy through additional employment and value creation as it provides the room for small growth oriented companies to achieve further growth as they migrate through different phases of the mid-cap market structure.

b. **Derivatives and risk management**: The SIV framework provides complying investments may be made in derivatives only if the investment is made for risk management purposes and is not a speculative investment. Paragraph 7 of the Explanatory Statement to the Instrument notes that complying investments should not be "used speculatively or for hedging market exposure". Austrade invites views on whether, to provide greater clarity on the scope of risk management purposes for the purposes of the SIV, the Instrument should specify: that complying investments may only be made in a derivative if the investment is not designed to substantially reduce or completely eliminate the exposure of an investor to the risk of loss from changes in the market price of an investment; and that hedging of currency and interest rate risks is permitted, however capital guarantee products should no longer be considered complying.

A: We support broader use of derivatives for certain yield enhancement purposes and for risk management purposes. We would also invite consideration of a broader use of derivatives, with appropriate limits and safeguards. This is because derivatives can be a legitimate way in which a fund achieves value and may be a key element of a fund's investment model.

A commonly accepted definition of market risk is that "market risk refers to the risk of losses … due to changes in equity prices, interest rates, credit spreads, foreign-exchange rates, commodity prices, and other indicators whose values are set in a public market"[7]. As such, where a derivative is entered into for risk management purposes, for example by looking to manage the risk and reduce the volatility associated with movements in interest rates, foreign exchange rates or market prices, then it would typically involve a hedging of market exposure or risk.

Derivatives therefore support the functioning of an efficient market by supporting price discovery and liquidity. If a market at the time of investment is highly volatile, or in the assessment of the investor the downside risks outweigh upside potential, then the use of derivatives in managing market risks is a legitimate form of market activity in any market.

Section 9 (Emerging Companies) and Section 10 (Balancing Investment) of the Migration (IMMI 15/100: Complying Investments) Instrument 2015 ("the Instrument") both permit an investment in derivatives to be treated as a complying investment. Sections 9 and 10 are to be read subject to Section 11 which provides that derivatives only constitute a complying investment where the investment is made for risk management purposes and is not a speculative investment.

The Explanatory Statement to the Instrument, at paragraph 7, provides that a complying investment should not be "used speculatively or for hedging market exposure". For the reasons as noted above, the reference to "hedging market exposure" appears to be at odds to the provisions of the Instrument which provides that it is acceptable to utilise derivatives for risk management purposes.

We would welcome Austrade providing additional clarity on the distinction between risk management purposes (an acceptable use of a derivative) and hedging market exposure (an unacceptable use of a derivative).

We agree with the view that the use of derivatives should not completely eliminate the exposure of an investor to the risk of loss regardless of market. Eliminating loss totally is only possible with a capital guaranteed product (see our response below).

In relation to both emerging companies and balancing investments, the timing of the investment is a product of the application process and the time in which the investor has to make complying investments under the Instrument. At the time of investment, market circumstances could be such that the downside risks far outweigh the potential for upside gain. In this scenario, the availability of limited downside risk products is crucial to preserving the potential for investors to gain from their investment over the complying period of their SIV.

We note that the use of a limited downside risk product does not mean that the intent and purpose of the legislation is not fulfilled. Limited downside risk products continue to incorporate an investment in the underlying security and therefore capital invested through the SIV channel will continue to flow through to the invested market.

[7] McKinsey Working Papers on Risk, Number 32 Managing market risk: Today and tomorrow

In line with our answer above, we support Austrade's position that hedging of currency and interest rate risk (as a subset of market risks) should continue to be permitted.

We support a position where capital guaranteed products should not be considered to constitute a complying investment.

Consistent with our comments above on derivatives, we believe hedged/ limited downside risk products should continue to be complying investments.

In our view, the key differences between a capital guaranteed product and a limited downside risk product is outlined in the table below:

	Capital guaranteed	**Hedged or limited downside risk product**
Type of risk exposure	Typically no downside market risk exposure, although it can also be guaranteed at "below par"	Investor is exposed to downside market risk, with the level of risk exposure subject to the efficacy of the implemented hedging program
Amount of risk exposure	Known upfront **prior to investment**	Level of risk exposure only known **after investment and after the hedge derivatives have been fully transacted**
Investor returns at maturity	Known upfront **prior to investment**	Can be estimated prior to trade but investor returns are only crystallised on maturity and continue to be subject to market risk (on both capital and income) during the investment period
Credit support	Typically marketed and supported by a credit rating	Not supported by a credit rating (although counterparty risk is present and typically disclosed to investors)

Sitting between an unhedged exposure to complying investments and a capital guaranteed product sits a continuum of partially hedged exposures. We note that Austrade is seeking views as to whether an investment in a derivative that substantially reduces exposure is also against the intent of the Instrument. Whilst we conceptually agree with Austrade that an investment should retain a material level of exposure in order to be treated as a complying investment, we would caution against constructing a test that refers to a substantially reduced exposure. Such a test would be ambiguous and open to interpretation. Rather, we would suggest that Austrade set a "bright-line" test that clearly described the level of hedging that would be considered acceptable.

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In constructing a bright-line test, Austrade should be careful not to create any unintended consequences. For example, as Austrade have alluded to in the question, it is foreseeable that a managed investment fund could invest in a fixed-rate bond issued by an ASX-listed company and to seek to hedge out the interest rate risk (i.e. from fixed rate to floating rate). This could potentially result in an investor's exposure to movements in the market price of the investment being substantially or completely eliminated.

c. **Cash holdings in a fund of funds**: The SIV framework requires no more than 20% of a managed investment fund's net assets be invested in cash held by Australian ADIs. However, it may be unclear how this requirement applies in a fund of funds structure. Austrade seeks views on whether the Instrument should specify that complying investments may not result in more than 20% of an investor's emerging companies or balancing investments being invested in cash held by Australian ADIs; and that investors need to have regard to the balance sheets of the companies in which their emerging companies or balancing investments are ultimately made when determining their cash holdings.

A: As a general comment, we are supportive of Austrade seeking to clarify how the limitation on cash held by Australian ADIs (being limited to 20%) applies in a fund of funds structure.

We also consider that there may be instances where for portfolio management for capital preservation reasons a fund will need to exceed that cash limit. Also, a SIV investor may need to switch out of one fund which is not performing into another fund, however will need time to complete the appropriate level of due diligence on the new fund. To allow for these situations we believe that cash in excess of the limit should be permitted for a limited period of up to 180 days.

Notwithstanding our support, we note there appear to be unintended consequences for the approach presently utilised.

For an asset manager, the suggestion to look through to underlying company balance sheets is impossible, as asset managers do not have such access.

Additionally, and by direct relationship, for a Fund of Fund (FoF) to ensure a 20% cash cap is adhered to at the 'top level' is also impossible, as it would require the FoF to firstly monitor its cash levels, plus get daily reports from the asset manager on its daily cash levels and then the presently impossible aspect of the asset manager providing cash exposure of underlying balance sheets - all of this is required to ensure the cap of 20% is not exceeded. Even in the local regular retail/wholesale/platform asset management industry, this is not recognised as standard (look through to balance sheets).

An example - if in a certain case an asset manager is holding close to the 20% limit on cash, for example 19%, and the FoF holds 2% in cash, the overall 20% limit is exceeded (**now 21%**) and the investor's visa condition may be at risk of breach. In practice a stalemate may ensue - the FoF may turn to the asset manager and demand a reduction in cash; the asset manager in turn and in accordance with its fiduciary duties will not be able to comply with the request as it may have direct investors also which holding 19% is not a problem for. It cannot sacrifice an investment outcome for one set of investors at the expense of another set.

Potential solution: 'Cash' at a fund level has always been understood to refer to cash held only by the pooled fund. If this is a concern, consider an increase in the FoF cash limit from 20% to a higher number (e.g. 25%) and keep 20% for direct investments (per status quo)

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d. **Complex fund of funds and IDPS structures**: The SIV framework permits the use of funds of funds and investor directed portfolio services (IDPS). However, there is currently no limit on the complexity or number of levels a fund of funds or IDPS structure may have, which can make it difficult to assess the compliance of the structure. Austrade seeks views on whether the Instrument should specify: a fund of funds or IDPS may invest directly in complying investments, or indirectly through another fund or entity that invests in complying investments, but that fund or entity may not invest through another fund or entity.

A: Consideration must be given to the benefit that the FoF and IDPS have brought to the market. If a limit on underlying levels is introduced, the IDPS (with its current pool of assets/investors) may not have sufficient size to then gain access to the market exposure it desires.

The benefit of a pooled fund is by definition the pooling of investor money to then gain access to a particular market. In emerging companies, access to an appropriately diversified portfolio is not possible with a sub scale size portfolio.

In order to avoid any further complication of structures and deterrence of SIV investors, we suggest that the levels of inter-funding should be kept as flexible as possible. Without exploring specific examples that Austrade has in mind, any change in this regard could leave existing IDPs and FoF without access to appropriate vehicles/portfolios to fulfil the instrument's requirements.

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Annexure C - Key miscellaneous 'downstream' concerns that may be associated with changes to the CIF/SIV framework

We provide the following commentary/response on alleged SIV abuses, which are said to be occurring in three main ways:

1. Chinese immigration agents and their partners charging up to 7% up front for migration referrals – making any real return on SIV money almost impossible

Whilst such fees are uneconomic for the SIV applicant, they are willing to pay them and we are not in a position to have jurisdictional control over such matters. However we recommend that only agents in Australia who are registered with the Office of the Migration Agents Registration Authority (OMARA) be able to provide the visa services. We note through our members experience that there are only a very small number of investors who do not use a migration agent. Migration agents could certify that the SIV applicant has not been charged more than a specific percentage as a way of mitigating this concern.

2. Specific SIV scheme promotors were allegedly doing 'loan-back' arrangements not intended by legislation

Specific participants have allegedly developed and distributed 'loan back' schemes, whereby the SIV investment became collateral for a loan made in the applicant's home country (generally, China).

This has now been fully addressed by the July 2015 Immigration Regulations (1994) amendment at Section 5.19C(4)(b) which was an FSC recommendation and states the SIV investment… "*must not form the basis for security or collateral for a loan*".

3. One large Australian legal firm also operating in China, was advising Chinese developers to form their own 'Managed Fund' and then collapse the fund to own the properties outright.

Our proposal to address this was that the Manager of the SIV compliant Investment Fund must always be <u>independent</u> of the SIV applicant, and of sufficient scale (c$500m in FUM) that the reputational risk of loss or suspension of their AFSL by ASIC, will ensure compliance.

We note this has also been addressed fully by the July 2015 amendments by requiring a minimum threshold for Managed funds operators' of c$100m in FUM; so no start up schemes can be compliant. We recommend the threshold be lifted again to c$1,000 million.