25 September 2017

By email: CIVreform@treasury.gov.au

Draft legislation on Corporate Collective Investment Vehicles

The Financial Services Council (FSC) welcomes the opportunity to make submissions on the draft legislation to implement a Corporate Collective Investment Vehicle (CCIV) for Australia.

The 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 is a strong proponent of the establishment of a CCIV regime in Australia. Along with the Asia Region Funds Passport, this new structure is vital to securing Australia's growth prospects and will deliver on key recommendations of the 2009 Johnson Review, *Australia as a Financial Centre — building on our strengths*.

We thank the Treasury for the substantial work that has been put into developing this important regulatory reform. The FSC submission makes recommendations to improve the regime; these proposals have been developed in consultation with our members to maximise the likelihood that the new regime is successful.

Please contact me with any questions in relation to this submission on (02) 9299 3022.

Yours sincerely,

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Introduction

The FSC has for some time supported reforms to introduce a corporate collective investment vehicle (CCIV) and a limited partnership collective investment vehicle. The introduction of these vehicles are important reforms to promote Australia as an exporter of financial services to Asia.

Broadening Australia's range of collective investment vehicles was originally a recommendation of the 2009 Report, *Australia as a financial centre – building on our strengths* (the Johnson Report).

The new range of collective investment vehicles should increase exports of Australian investment products, as foreign investors will have Australian investment products that are more familiar and more internationally acceptable.

The new CCIV will allow Australian fund managers to compete globally, if it has an appropriate cost structure.

This submission considers a wide range of issues that we consider are important to ensuring the new CCIV regime is successful. We also note changes to Australia's withholding tax regime for managed funds remain essential unfinished business and should be addressed as part of this process.

General comments on cost

The CCIV regime needs to be efficient and competitive in order to encourage Australian fund managers to adopt the CCIV regime and increase the volume of Australian funds being offered in foreign markets including in Asia.

In particular, the regime needs to be competitive with the costs of running similar structures in Australia and overseas. If the CCIV regime is too costly, then Fund Managers (and importantly Australian Fund Managers) will continue to utilise the existing MIS regime, or look to more competitive jurisdictions such as Hong Kong (as discussed below) to establish collective investments vehicles instead of establishing Australian CCIVs.

If managed funds are established offshore instead of in Australia, this is likely to reduce the size of the Australian financial services industry, resulting in a reduction in economic activity and employment.

The regime also needs to be competitive compared to the current managed investment scheme (MIS) rules, taking into account the benefits of CCIVs compared to MISs. If the CCIV regime is not competitive, then fund managers will likely choose not to transition funds into the new regime or establish new funds as CCIVs.

The particular cost concern of FSC members relates to the regulatory requirements placed on the depositary. One FSC member has estimated the cost of this element of the CCIV structure to be 10 basis points; another has estimated 3–15 basis points. We would be able to put Treasury in touch with the relevant FSC members who can provide more details of these costs. Note these calculations may be underestimates, as the proposed independence requirements for depositaries could reduce competition and increase costs, and the high threshold for replacing a depositary will have similar effects. These cost-increasing aspects are discussed in more detail below.

The additional cost has a direct impact on the competitiveness of the CCIV structure compared with the existing Australian MIS regime and international collective vehicle structures such as the Hong Kong Open-ended Fund Company (OFCs), which does not have the requirement for a supervisory depositary.

- The role of the custodian for Hong Kong OFCs is limited to the 'safe keeping of scheme property'. There is no oversight requirement.
- The cost of the depositary as currently proposed may mean Australia's CCIVs will not be able to compete with Hong Kong's OFCs on price once the Asia Region Funds Passport (ARFP) is operational. Hong Kong's OFCs will be able to be marketed in all participating jurisdictions, including Australia, under the ARFP.

The proposed approach for CCIVs appears to conflict with the policy objective of creating a competitive collective investment vehicle in Australia to attract international investors.

FSC is concerned that the requirements on the depositary may mean the CCIV regime reintroduces the slow and inefficient investment process before the *Managed Investments Act* 1998 when Australian law required a separate manager and trustee. A significant reason for the replacement of the earlier regime was to make a single entity responsible for operating collective investments and avoid the two parties blaming each other and spending months in court, as happened after the collapse of Estate Mortgage.[1]

- When a separate trustee and manager was required, the trustee required a fee of approximately 10 basis points on top of the fee charged by the manager. This is similar to the cost estimates of FSC members for the depositary (see above).

The additional cost of the CCIV regime is significantly affected by the requirements on the depositary. This submission highlights a number of policy changes to the Draft Bill that should reduce this cost.

- The depositary provides an important benefit in a separate entity holding assets on trust, rather than assets being held directly by the CCIV. This provides important investor protections. A depositary that more closely reflects the existing role of a custodian is preferable to one taking on many other roles, at a cost.

There are other factors in the Draft Bill that affect costs. The Draft Bill does not allow the alternative of a compliance committee but requires at least half of the directors of the CD of a retail CCIV to be independent, which seems likely to increase cost. The Draft Bill does not allow for the choice of using a compliance committee.

Issues relating to depositary

Independence requirements

The draft bill proposes stringent requirements for independence of the depositary and its agents from the corporate director (CD) and its agents and associates. These requirements are too strong in FSC's opinion, for the following reasons:

- The independence requirements, particularly the voting power test in s1163C specified in the Draft Bill, imposes a disadvantage on up to half of the top 10 providers of custody services in Australia, because they are integrated service providers — the approach in the Draft Bill would mean these providers could need to transfer the assets managed by their investment management division to one of their competitors in order to adopt the CCIV regime. This would require restructuring, and could reduce competition and increase the

[1] See the 1993 CAMAC report, *Collective Investments - Other People's Money*, for a compelling exposition of these issues.

cost of the services, which would ultimately be paid by consumers including Australian retirees. This will also limit the demand for the new CCIV regime.

  - The development of IT systems to run custody and administration services is a lengthy and expensive exercise that can only but undertaken by substantial organisations.

- The ARFP regime does not require either Australia or the other participants, against whom Australian funds managers will be competing, to meet independence tests for the depositary of the kind set out in the Draft Bill. The ARFP does require separation of the functions of asset holding and investment, and ability for the depositary to act independently from investment officers. That is similar to the requirements for custodians of Managed Investment Schemes under RG 133.
- The test in the Draft Bill is said to be based on the UK's open-ended investment company (OEIC) model, but the Draft Bill goes further, in that it entrenches the test in legislation rather than only in a guidance document which is flexible, and in s1163C(1)(b) imposes the independence test on agents of the depositary.
  - Paragraph 15(8) of the UK's OEIC Regulations says that the person appointed as the depositary of the company must be independent of the company and the directors of the company. The meaning of "independent" is not in the Regulations, but rather in guidance in the FCA Handbook, COLL 6: Operating duties and responsibilities. While it describes what the FCA considers may amount to independence, there is the option of looking at "independence … safeguarded by other means" and the cross-shareholding test refers to the ability of one of the relevant parties to "control the actions of the other by means of shareholders' votes". That is less prescriptive than the voting power test in s1163C(3) of the Draft Bill. That section embodies a complex concept with drafting borrowed from Australian takeover law which is not simply focused on avoiding conflicts of interests, which is (or should be) the purpose of the provisions here.
  - The UK approach should not be mirrored as strict legislative prohibitions in Australia because the market for financial services in Australia is much smaller than in the UK, with a small number of large providers.
- For large full service financial institutions the proposal in the Draft Bill would restrict the ability to appoint a group company as depositary even if there are clear Chinese walls in place between the two businesses using, for example, separate legal entities, boards and segregation of information flow and similar. Large full service financial institutions providing a complete service through separate local entities and boards, with the same ultimate parent entity shareholder, would be adversely impacted by these independence requirements.
- In Europe independence requirements were debated with the introduction of UCITS V. For some time there had been the ability for the Management Company to be part of the same group as the depositary. In Luxembourg, if this were the case and in order to maintain a sense of independence, then there were prescribed requirements — particularly that conducting officers of a management company could not be employees of the depositary and that the Board of the Management Company could not be predominantly composed of representatives of the business line of the depositary bank and vice versa.
  - The debate over UCITS V contemplated either complete independence between the two or the requirement where the depositary bank was a connected party to mandate that independent directors must sit on Management Company Boards. The

EU went down the second path.[2] The principal reason why the latter option was taken up was to do with the provision of services by banks. In the EU, apart from the UK, banks generally provide a complete service — transfer agent, administration, custody and depositary functions.
    - The UCITS V approach is internationally acceptable, so the Australian CCIV regime could follow this approach.
- The Draft Bill has factors mitigating the need for a strictly independent depositary including that the CD must have at least half of its directors as independent (s1156B), and a requirement for a compliance plan and a compliance plan auditor.
- The requirement for the depositary to hold an AFSL will also bring with it the usual licence conditions, including the requirement to have in place adequate arrangements to manage conflicts of interests. This is a well understood concept with significant regulatory guidance. This curtails the need for strict independence requirements.
- In circumstances where a custodian acts also as fund administrator it is not clear how structural separation between the custodian and administrator achieves anything recognising that both parties are not strategic decision makers, but in effect operate on instruction.

There are also some technical issues with the test of independence proposed in the Draft Bill: the associate test in s1163C(2) is difficult to apply in practice; and the 0.5% voting shares test in s1163C(2) is a very low threshold, making this impractical to implement where the CD may not have the relevant information at that threshold.

To address these issues, the FSC argues other models for independence should be implemented.

- One approach is to replace the tests in section 1163C of the draft bill with a requirement that the depositary be required to be "functionally independent" in line with IOSCO standard 3 for the custody of collective investment scheme assets and the UCITS V Directive.[3]
    - This would also be consistent with the Luxembourg SICAV requirement (implementing UCITS V)[4] for the manager and depositary to be, in the exercise of their respective functions, acting in a manner which is independent and exclusively in the interest of the investors and in a manner which is honest, loyal, and professional. A requirement to *act* independently is more achievable and appropriate than the structural firewalls prescribed in the Draft Bill.
- The CCIV regime could mirror and build on the asset-holding standards for custodians and responsible entities under ASIC Regulatory Guide 133 as implemented in Class Orders 13/1409 and 13/1410. ASIC and the industry have devoted substantial time and expense on the introduction and implementation of this system.
    - The concepts under that regime, including in relation to separate reporting lines, reconciliation and how global subcustodians networks are monitored, including in countries where trusts are not recognised, are understood by the funds and custody industries and can be the basis for what is expected of a depositary.

[2] See European Commission's Delegated Regulation 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries, Chapter 4

[3] We understand a similar proposal is contained in the submissions on the Draft Bill by Herbert Smith Freehills and King & Wood Mallesons.

[4] Memorial Journal Officiel du Grand-Duche de Luxembourg, Recueil de Legislation, A – No. 88, 12 May 2016

- FSC also considers there is a good case that s1163C, which is based on guidance provided by the FCA in the UK, should not be codified in the law (see the discussion on this issue above).

Replacement of depositary

The FSC considers it is too onerous to mandate that a depositary can only be removed or replaced by a special resolution of the members of the CCIV. This presents a significant hurdle to the replacement of depositaries and could be anti-competitive as depositary providers become entrenched even if they are expensive and inefficient in their role. It also means it will be difficult to replace a depositary on legitimate grounds including material breaches, poor performance, insolvency, or ceasing to meet independence tests.

- Making it harder to replace a depositary is argued to increase the depositary's independence and hence the protections for investors. However, an entrenched depositary that is hard to remove could conversely lower service standards and investor protections.

The proposed approach to replacement also assumes that the CCIV investors are best placed to evaluate between depositaries and to elect a replacement depositary — this is a questionable assumption.

We note the current MIS system allows the responsible entity to replace a custodian on relatively short notice, and this arguably provides incentives for high standard of performance.

Instead of this approach, the depositary should be able to be changed by the CD, rather than by a meeting of the members of the CCIV. Such an approach would be in line with the United Kingdom's regime for the OEIC, which provides for a change in depositary to be made the by directors of the company.[5] The CD of a CCIV is likely to be in a better position than investors to determine the relative merits of depositaries, and allowing the CD to make the change would be more cost-effective than requiring a meeting of the members of the CCIV.

If it is considered that further investor rights and protections are needed beyond what applies under the managed investment scheme regime in relation to custodians, options include:

- Requiring the regulator (ASIC) to give approval for a change in depositary, mirroring the requirement under the UCITS directive.
- A requirement that the CD can only remove the depositary where it reasonably considers that it is in the best interests of the investors. This is equivalent to the existing powers on responsible entities to replace a custodian, and involves fiduciary protection for investors.

Actions of depositary

The Draft Bill states that the depositary may only deal with assets it holds only on instructions from the CD that are lawful and comply with the CCIV's constitution (s1164A).

FSC considers this requirement is too onerous. On the face of it, this would require an assessment by the depositary of lawfulness of a trade before the order is processed, which would be expensive,

[5] *Open-Ended Investment Companies Regulations 2001* Schedule 1 reg 2. This requirement is subject to a notice requirement for the company to inform the Authority of the proposed change in depositary, and subject to the Authority's right to seek a court order to remove and replace the depositary with the choice of the Authority.

impractical[6] and may lead to claims on the depositary if a transaction they delay or deny in good faith turns out to be lawful.

A more efficient, realistic and still robust approach would be to adopt the AIFMD and UCITS V approach of "ex-post controls and verifications of processes and procedures that are under the responsibility" of the fund operator.[7] Post-trade verification would be able to use automated checking systems, which would be both more reliable and less expensive for consumers. Under this approach, the depositary of a CCIV should only be able to refuse to deal with assets the depositary holds on instructions from the CD if the depositary reasonably considers that the instructions are not lawful or do not comply with the CCIV's constitution, or as otherwise provided in the agreement between them. This last limb is needed to cover matters such as unclear, obviously erroneous or unauthorised instructions.

This would also entail changes to s1164B to say that the depositary must verify (not ensure) that the CD has conducted the activities listed in the section in a manner that did not contravene the CCIV's constitution or the Corporations Act.

Other issues relating to depositaries

The FSC also considers there are various other issues relating to the requirements on depositaries:

- Section 1164B(3) should not prohibit the depositary from using agents to assist in its checking function; rather it should be able to outsource mechanical functions, but could be held responsible as if it had carried out those functions itself. It is recommended that it be clarified that the depositary may engage employees, consultants, contractors and employees of related bodies corporate to carry out these functions.
- The proposed duty of the depositary in 1164D(d) to treat CCIV members equally and fairly is not needed, as the depositary will be acting on the corporate director's instructions, and will have no discretions which allow scope to control how members are treated.
- Section 1164F provides for certain duties of the depositary to override conflicting duties of an officer or employee of the depositary. It is recommended this is clarified as a duty owed by one party (the depositary) are not the same as the duties owed by a different party (officers or employees of the depositary).
- The Draft Bill states that the CD may not appoint the depositary as an agent to do anything the CD is authorised to do (s1138A(2)). This could severely restrict the types of services the depositary can provide to the CCIV and appears to be inconsistent with the current practice for some custodians to carry out administrative functions and other services such as foreign exchange, securities lending and banking services.
    - Currently, the custodian, as the holder of assets, already has the information about the assets and the data feeds to securities exchanges and, in many cases, a global network of subcustodians. A requirement to change that practice and have a separate administrator seems more likely to harm than help investors, because of the additional complexity with attendant risk of error, and cost from duplication.

[6] For example, a depositary would have to be so familiar with the terms of its clients' different constitutions that it could make assessments of proposed trades in real time.

[7] As described in the IOSCO report *Standards for the Custody of CIS Assets, FR 25/2015*.

    - The restriction proposed in the Draft Bill could increase costs for investors as the depositary may be able to provide these services more efficiently than the CD.

Liability of depositary for actions of others

The Draft Bill provides, under s1164(4), that the depositary is taken to have done or failed to do anything its agent does or fails to do, even if the agent is fraudulent or acting outside authority. The FSC considers this provision to be too onerous, as it will mean depositaries will effectively be required to use a related company to act as agent, so that trading is not offered in countries where they do not have a branch. Most, if not all, potential depositaries will not offer services on the basis of strict liability for unrelated agents. It is not practical for a business to have strict liability for another business over which it has no control. This liability requirement is also likely to increase the costs of the depositary service.

The UCITS V approach would be preferable for Australia, which does not involve strict liability. UCITS V requires an objective reason for delegation, care in selection, supervision, audit and taking all necessary steps to ensure that assets of the UCITS are not available on insolvency[8] (for example that they are held on trust by the subcustodian or have other insolvency protection appropriate to the laws of the relevant jurisdiction, which may not recognise trusts, along the lines required under the Class Orders related to ASIC Regulatory Guide 133).

Retail and wholesale CCIVs

Definition of retail & wholesale

FSC is concerned that the definition of 'retail' CCIV in the draft is unnecessarily broad. In particular:

- One retail client should not be enough to make a CCIV retail.
- A CCIV should not be retail just because the promoter of the CCIV also promotes retail CCIVs (s1154A(2)(b)).
    - If retained, this subsection could make it impossible for any investment group that offers retail CCIVs to also offer wholesale funds.
    - In addition, the term 'promoter' is not a clear concept.

If this approach to defining retail is maintained, it seems likely that wholesale funds will choose to be established as MISs, and many existing wholesale funds will not choose to become CCIVs, as they will likely be classified as retail funds in the CCIV regime.

Requirements on wholesale schemes

Some of the requirements on wholesale CCIVs appear unnecessary. In some cases, the requirements for all CCIVs (both wholesale and retail) replicate the requirements on registered schemes, even when the requirements do not apply to wholesale unregistered schemes. It would appear reasonable to allow equivalent treatment under both MIS and CCIV regimes.

The requirements for wholesale CCIVs that appear unnecessary include the following (note some of these requirements are also discussed in other sections of this submission):

- The rules relating to the replacement of the corporate director. Currently wholesale scheme constitutions usually set out the process for replacement of a trustee and can therefore be less prescriptive than the registered scheme rules. A similar approach could be used for wholesale CCIVs.

[8] From IOSCO report, see footnote 7.

- Liability of a CD for the action of agents. The relevant rules for registered schemes do not apply liability to wholesale unregistered schemes. Instead, the constitutions of the wholesale schemes usually set the standard of liability, or general trustee duties would apply. A similar approach should apply to wholesale CCIVs, allowing liability standards to be set by the CCIV constitution.
  - This point equally applies to sub-agents of the corporate director.
- Requirement for CD to be a public company (not required for trustees of wholesale unregistered schemes).
- Lodgement of constitution of the CCIV with ASIC (not required for constitutions of wholesale unregistered schemes or proprietary companies).
- The requirement for external directors in s1156B(1).
- The provisions relating to dealing in capital (financial assistance in s1148; self acquisition in s1147; redeemable shares in s1143; share capital reductions in s1146A).

The Draft Bill also indicates an election by a wholesale CCIV to have a depositary is irrevocable: a wholesale fund that chooses to have a depositary cannot revoke that choice later. It is not clear why there are not provisions for a wholesale fund to decide that it no longer needs a depositary. The protections relating to the replacement of a depositary would apply to removal without replacement (see discussion of these requirements elsewhere in this submission).

Sub-funds

FSC welcomes the Draft Bill's flexibility allowing a number of sub-funds to be established in CCIVs with separate assets and tax treatment.

Voting by sub-fund

Section 1155A of the Draft Bill provides that the primary method for amending the constitution of the CCIV is by "special resolution of the members of the CCIV". However, there are likely to be amendments put to a vote which affect only some of the sub-funds, and it would be inconvenient, expensive, and irrelevant to send meeting materials to investors in the other funds and for them to be entitled to vote. In addition, allowing people who have no investment in a sub-fund to vote on resolutions of that sub-fund could generate unfair results.

Instead, for constitutional changes only affecting sub-funds, the requirement should be for special resolution of the members of the affected sub-fund(s) alone.

Sub-funds investing in the same asset

Section 1142E(4) of the exposure draft states an asset must not be allocated to more than one sub fund. The Explanatory Material (para 4.41) states that this provision: "… prevents 'joint investments' in a single asset by multiple sub-funds of the same CCIV. However, this is not intended to prevent multiple sub-funds in a CCIV from investing in a single physical asset through a trust or other ownership arrangement, provided that each sub-fund's interest is separately identified and transferrable."

The FSC queries whether this restriction is needed. If an asset is to be beneficially owned by more than one sub-fund, would it not suffice it to say the asset must be fully allocated to sub-funds (neither over- nor under-allocated). The benefits from requiring an interposed entity (such as a trust) are unclear. In particular, it is not clear how joint ownership without the interposed entity increases the risk of cross-contamination compared to joint ownership *with* an interposed entity.

Other issues relating to sub-funds

To improve the operation of the CCIV regime, the FSC recommends some other changes to Division 3 of the draft Bill in relation to sub-funds:

- Section 1142C(3) allows a court to change the application of assets to a sub-fund in "the interests of justice". We have a concern that this may not provide sufficient commercial certainty. Contractual arrangements should not be overturned on a subjective basis of being 'in the interests of justice'.
- Section 1142J(3) states that if liabilities are not allocated by the CD as required, the CD must allocate them in a manner that is fair and reasonable. The FSC is concerned that allowing discretion in this area is unlikely to be satisfactory when the very reason for this discretion is that the CD has failed to fulfil the primary duty of allocation. A default position should apply such as allocating expenses in proportion to the net asset value of the sub-funds of the CCIV.
    - One other option is to provide that both assets and liabilities should be allocated in the manner provided for in the CCIV's constitution, or in the absence of such a provision, in a manner that is fair and reasonable.
- There would be value in a provision to allow a person dealing with the CCIV to assume that records of the sub-fund assets and liabilities are correct unless the contrary is proven.
- The CCIV regime would likely benefit from rules providing a strict quarantining of assets and liabilities within each sub-fund, thus preventing the assets of one sub-fund from being used to satisfy the debts of another sub-fund.
- Cross funding or inter-funding of sub-funds should be allowed — this is considered in the dealings in capital section below.
- It would be preferable for the retail/wholesale classifications to be tested at a sub-fund level rather than for the whole CCIV. This would in particular mean that the costs of the depositary are only imposed on the retail sub-funds in a CCIV.
- There would be value in allowing sub-funds to transact with each other, for example to transfer an asset from one sub-fund to another.

There are some complex issues relating to the approach in the Draft Bill with sub-funds not having separate legal personality. Some of these issues include:

- While assets and liabilities in sub-funds may be quarantined from other sub-funds under Australian law, it is queried whether this quarantining/segregation will work as designed in overseas jurisdictions.
- Will the status of a sub-fund for various tax purposes affect other sub-funds; for example if one sub-fund is land rich for stamp duty purposes, will this impact on other sub-funds?
- The consequential provisions will deal with winding up and insolvency. Under the UK's OEIC Regulations[9], the sub funds are not separate legal persons, but the property of a sub fund is subject to orders of the court as it would have been had the sub fund been a separate legal person. Also, an umbrella company (comparable to our CCIV) may sue and be sued in respect of a particular sub fund and may exercise the same rights of set off in relation to that sub fund as apply in respect of companies. The UK's approach might be worthwhile considering in the Australian context.
- In practical terms, how would an administrator or manager be appointed to an insolvent sub-fund if that sub-fund does not have legal personality?

[9] OEIC (Amendment) Regulations 2011, No. 3049, section 11A inserted by item 3.

- Sections 1160A and 1160B refer to a listed CCIV or unlisted CCIV. It would create a number of problems if only the CCIV could be a listed entity. The entity that lists under ASX rules should be the sub-fund, as it has the separate pool of assets and liabilities in which investors would invest by trading. Some amendments to the Listing Rules will be needed to accommodate this, by analogy of the CD with a responsible entity, each of which can operate more than one fund which are not separate legal persons, but the concept will also need to be reflected in the Draft Bill.
- It would also need to be clarified in the forthcoming tax draft if sub-funds will have their own ABNs and TFNs.

Dealings in capital

The FSC considers the rules relating to capital in the Draft Bill should be made more flexible.

Capital reduction

The FSC considers the requirements in s1146A that a capital distribution should have to be fair and reasonable to members of each affected sub fund and approved at a meeting of sub-fund members are inconsistent with the common use of capital distributions from managed investment schemes.

For example, a half year distribution may include a component of capital along with income.[10] This is partly because the responsible entity does not know until the end of the financial year whether the amount they are distributing will be characterised as capital or income. Further, capital distributions are often made in tranches during the course of winding up a fund as assets are sold, and applied in the context of transactions such as stapling where authorised under the trust constitution. If capital distributions are made pro rata and do not threaten solvency, there is no reason why they should not be at the discretion of the corporate director. The only limit on capital return should be to ensure that a capital reduction is not inconsistent with the solvency of the sub-fund. The application and redemption processes for a CCIV should mirror those for a managed investment scheme.

Redemptions by the corporate director

Collective investment funds need to have the ability to redeem securities without a request from the holder, as provided in the fund's constitution and as disclosed to investors. Examples include where the CD needs to recover from the investor an expense or debt including a tax liability which the investor has caused to the fund, or if the investor is not qualified (eg wholesale, or of a particular character for stamp duty purposes) and so its continuing holding adversely affects other members. Relevant sections include 1143, 1144A and 1146B(a).

Self-acquisition & interfunding/cross-funding

The FSC considers it is unclear why the prohibitions on self-dealing in shares (in sections 1147 and 1147A) are needed. The rule does not apply to managed investment schemes. The proposed prohibition would prevent interfunding among sub-funds, because the CCIV would be unable to acquire shares other than for a redemption. Interfunding is a common and efficient method of management. A prohibition on interfunding would prevent various forms of funds management, for example:

- a hedged fund can invest the bulk of its assets in an unhedged fund with the same investment mandate, and the investment decisions need only be implemented for one fund.

[10] References in the Draft Bill to "dividend" should be changed to "distribution" for this reason.

- Internal market-making activities currently used by a number of exchange traded managed funds quoted on the AQUA market.
- A common arrangement where a fund manager might have funds relating to specific asset classes (fixed interest, global securities, real estate) and then a series of diversified funds investing in each of these underlying funds.

The prohibition on interfunding could also be problematic for transition and merger arrangements.

Constitutions for managed investment schemes will commonly provide that the trustee/responsible entity is entitled to acquire units in the trust, for reasons including the above. The UK's OIEC Regulations expressly permit cross-sub fund investment.[11]

If the assets and liabilities of the sub-funds are properly ring-fenced by the legislation, the fact that one owns shares in another should not present any difficulties greater than if they were separate companies.

Financial assistance

The FSC considers that the proposed ban on financial assistance for share acquisition (s1148) provides an unclear consumer protection benefit. No such restriction applies to managed investment schemes. At the least it should be clarified that it is not intended to affect normal industry practices such as the CD or an associate providing margin loans or dividend reinvestment plans.

If this ban remains, it would appear valuable to provide a range of exemptions, mirroring s260A of the Corporations Act 2001, including for assistance approved by members and assistance that does not materially prejudice the company, its shareholders or creditors.

Other issues relating to capital

There are several other issues relating to dealing with capital:

- It is not clear why the Draft Bill states redemptions can only occur for fully paid shares and cannot occur for partly paid shares — see s1144A(1)(a). Redemption of partly paid units in a MIS at a formula-based price is permissible.
- The draft Bill states shares in a listed CCIV must be redeemed at market value (s1160B) rather than net asset value. It is not clear why the Draft Bill does not provide flexibility, for example so that redemption could occur at net asset value. These limitations would be better set out in ASIC guidance, as they are for MIS,[12] so that they are more adaptable to different transactions, such as a buy-back.

Other queries/suggested changes

FSC wishes to query the following issues, and make suggestions for changes:

- The Draft Bill proposes the timing of the change in CD will be when ASIC's record is updated (s1139). However, the old and new CD have no control over this timing, and may not necessarily know when this updating has occurred. Instead, the notice making the change in CD should state the change occurs on lodgement, or allow for the notice to specify a time when the change should become effective.

[11] OEIC (Amendment) Regulations 2011 No. 3049, section 11B inserted by item 3.

[12] See ASIC Class Order [CO 13/655]

- It is queried whether it is practical to give the CD only 14 days to appoint new independent directors if these independent directors are no longer in the majority (s1156B(4)). A preferable approach might be to require the appointment to occur as soon as practicable.
- It is not clear why the mandatory reporting requirements in the Draft Bill in s1164E do not use an existing test of whether the breach is 'serious', such as 'significant breach' in the AFSL mandatory reporting requirements or the 'material adverse effect' test in s1156(l).
- The legislation should provide for a CCIV to convert to a different type of company if it ceases to meet the requirements of the regime. Although this would obviously have tax consequences, it should be a choice available. An example would be where disposal of the assets would be more disadvantageous to investors than conversion to a public or proprietary company, so that the assets do not have to be sold in a period when market prices are low or difficult to ascertain. Currently s1139F(5) of the Draft Bill provides no other choice than applying to the court for an order to wind up the CCIV if it does not have a depositary.
- The Draft Bill imposes duties on both the CD and the depositary. A demarcation of liabilities between these two parties may be needed.
- Section 1149 provides that where ASIC makes CCIV rules, it must have regard to the objects of the new Chapter 7A, which include providing a regulatory framework for CCIVs that is fair, efficient and competitive (s1136). The same principle could be added to section 1149B, under which ASIC has power to issue legislative instruments of individual or general application. In particular, an instrument of general application may have a very similar scope and effect to a CCIV rule, so should be made on a similar basis.
- It is important that both the CCIV bill and any necessary amendments to ASX rules should clearly accommodate products which trade on the AQUA market of ASX, as well as on ASX's main board, having the form of a CCIV.