FSC FINANCIAL SERVICES COUNCIL

16 December 2024

Beneficial Ownership and Transparency Unit
Market Conduct and Digital Division
Treasury
Langton Cres
Parkes ACT 2600

By email: beneficialownership@treasury.gov.au

Dear Treasury

RE: Exposure Draft Legislation: the Treasury Laws Amendment (Enhanced Disclosure of Ownership of Listed Entities) Bill 2024

Introduction

The Financial Services Council (**FSC**) welcomes the opportunity to provide feedback on the exposure draft of the *Treasury Laws Amendment (Enhanced Disclosure of Ownership of Listed Entities) Bill 2024* (**Exposure Draft**).

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

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

The FSC supports the Federal Government's aim for increased transparency in order to "*address tax avoidance and improve corporate transparency*".[1] However, we are also concerned that the present scope of the Exposure Draft risks imposing a significant administrative burden on fund managers and superannuation funds, which are at low risk of perpetrating tax avoidance or other financial crimes. The FSC submits that activities "*intended to discourage the use of complex structures to obscure tax liabilities and facilitate financial crimes*"[2] should be pursued in an evidence-based and targeted manner.

It is important to acknowledge that fund managers and superannuation funds are not the primary targets of the Exposure Draft but might end up bearing significant expenses complying with it. The FSC is eager to work with Treasury to find pragmatic and proportionate ways to strengthen the proposal.

[1] Explanatory Memorandum, paragraph 1.5.
[2] Explanatory Memorandum, paragraph 1.6.

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The FSC has the following concerns regarding the Exposure Draft in its present form:

1. There is insufficient evidence to justify applying beneficial ownership reporting obligations to all cash-settled derivatives with equity underliers (**Cash-Settled Derivatives**) and they are not captured by similar regimes in key comparable jurisdictions;
2. Treating Cash-Settled Derivatives as a form of beneficial ownership may mislead the market through double-counting of beneficial interests. The proposed mechanism to address this under section 608B(3), which would confer power on ASIC to assign certain derivatives a value of zero, is likely to create unnecessary uncertainty for industry;
3. For physically settled derivatives, fund managers and superannuation funds in the bought position will in practice often not know the relevant interest that the counterparty has in the underlying shares. Therefore, requiring fund managers and superannuation funds to report separately on the nature of such interests is unlikely to provide any meaningful information to the market; and
4. Many fund managers and superannuation funds would not be able to comply with the proposed 6-month transition period, due to the nature of the system upgrades and changes to operational processes which would be required.

The FSC recommends that Treasury address these concerns by:

1. Maintaining the current approach to the reporting of Cash-Settled Derivatives;
2. If recommendation 1 is not accepted, then amending the Exposure Draft to both exempt index derivatives and make it clear that where ASIC assigns a derivative a value of zero, the owner is not obliged to report their ownership;
3. Amending the Exposure Draft to remove the distinction between "*relatable derivative-based holding percentage*" and "*deemed physically settleable derivative-based holding percentage*"; and
4. Extending the proposed 6-month transition period to 18-months.

Comments on the Exposure Draft

Cash-Settled Derivatives

Opposition to the inclusion of Cash-Settled Derivatives

Many fund managers and superannuation funds rely on Cash-Settled Derivatives as a way to gain an economic exposure to securities while minimising their trading costs. Many of these derivative transactions are undertaken solely to track an index or other benchmark as efficiently as possible. Most fund managers and superannuation funds do not invest in Cash-Settled Derivatives with an intention to exert influence over their underlying companies. Nonetheless, they do engage in very high volumes of these transactions which, under the Exposure Draft in its present form, would mean they would be subject to a significant reporting burden. As such, the FSC strongly contends that Australia's beneficial ownership laws should not be amended to require the disclosure of Cash-Settled Derivatives in the manner set out in the Exposure Draft.

The Explanatory Memorandum explains the limited circumstances in which it is technically possible for dealings in Cash-Settled Derivatives to be used to influence the market:[3]

> *While holding a cash settled derivative may not confer any express rights over underlying securities, the inherent incentive that the arrangement creates for a counterparty to hedge their exposure gives the person in the bought position a proximity and influence in relation to those securities that is relevant to the market.*
>
> *For example, the holder of the derivative may take advantage of commercial incentives that underpin the derivative. If the holder chooses to unwind the derivative (by exiting the arrangement or choosing not to exercise an option), the counterparty will, in normal market*

[3] Explanatory Memorandum, paragraphs 1.71 to 1.74.

practice, unwind their own position by selling their hedge position.

> *In this way, the investor can influence the timing of the derivative's unwind, and thereby have advanced notice of when a significant parcel of shares is about to come onto the market. This gives the holder an informational advantage to position themselves to acquire the disposed shares (or to negotiate to change the derivative to a physical settlement option).*
>
> *The extension will bring cash settled equity derivative positions into the existing disclosure requirements in recognition that these positions allow participants to exert influence over underlying securities and, in turn, over relevant entities. Appropriate disclosure of this influence is necessary to ensure the transparency of Australia's financial markets.*

The FSC suggests that, to the extent that such activities are not already within the scope of market manipulation prohibitions, rather than impose industry-wide reporting obligations in the manner contemplated by the Exposure Draft it would be more efficient and proportionate to specifically amend rules prohibiting market manipulation to address any intentionally manipulative conduct relating to the unwinding of Cash-Settled Derivatives directly.

Also, these paragraphs of the Explanatory Memorandum assume that the holder of the derivative has influence by virtue of being able to choose to unwind the derivative (for example, by exiting or not exercising an option), in which case the counterparty will, in normal market practice, unwind their own position (i.e., sell their hedge position). However, this is speculation only, and a fund manager or superannuation fund in the bought position is not typically aware of how its counterparty hedges (or even if it hedges) each transaction. A person in the short position, such as the writer of an equity derivative, may sit between a long- and a short-Cash-Settled Derivative, avoiding the need to hold the underlying security (and they often are incentivised to do so, to ensure that such derivative positions do not impact the market as far as possible). In such instances, particularly where there is no ability for the long-position holder to influence voting rights on the shares (especially if it is unaware of the hedge its counterparty holds), it is unclear why such Cash-Settled Derivative positions should contribute towards reporting thresholds.

The FSC also endorses the observations of the Managed Funds Association to the US Securities and Exchange Commission (**SEC**) in relation to a similar hypothetical example:[4]

> *The Commission's posited scenario is purely speculative and seemingly premised on false assumptions regarding clandestine relationships and agreements between cash-settled derivatives holders and their counterparties. To be sure, in a particular scenario, a seller of a derivative might hedge its risks by purchasing the underlying reference shares and might later choose to sell those shares to its counterparty, the holder of the derivative. But* ***this scenario is indistinguishable from the derivative holder's purchase of shares on the open market, absent a preexisting agreement for the seller to keep those shares and sell them to the derivative holder on demand****. The Commission has provided no evidence that such agreements are present, much less prevalent, in the market. Moreover, to the extent such an agreement did exist, the derivative holder would be considered to have beneficial ownership of those shares under the current rules, and would therefore be required to disclose.*

The FSC is similarly unaware of evidence that such off-market practices are present in the Australian market.

The FSC also endorses the observation of the Alternative Investment Management Association in a submission to the SEC that:[5]

> *the Proposal seems to believe that a counterparty immediately goes to the market to hedge its derivative position in what would be akin to one-to-one hedging. This assumption is incorrect and does not reflect market realities.* ***A broker-dealer counterparty will aggregate its exposure across all counterparties and hedge only its net position or may not hedge***

[4] MFA submission to the SEC dated 11 April 2022, page 24.
[5] AIMA submission to the SEC dated 11 April 2022, page 12.

***the position at all**. Unlike what the Proposal seems to contemplate, just because a position is hedged, does not mean that the broker-dealer can then deliver the referenced securities one-for-one to the derivative holder or even attribute shares that it may hold as a hedge, or the voting of any such shares, to any specific derivative transaction.*

The Managed Funds Association in its submission to the US SEC noted the following points in support of declining to expand beneficial ownership reporting to include cash-settled derivative securities: [6]

- Cash-settled derivatives do not convey voting rights but reflect a solely economic stake in the issuer;
- Expanding reporting to include cash-settled derivatives will simply create market confusion about which investors actually have the ability to influence or control the issuer; and
- Requiring reporting of cash-settled derivatives imposes a significant burden on the market.

On a fundamental level, Cash-Settled Derivatives only entitle their holder to an economic exposure to the underlying equity. They have not historically been considered to be a form of beneficial ownership because they lack the ordinary characteristics of ownership: control or voting rights. Problematically, conflating this form of derivative with beneficial ownership actually risks decreasing transparency because it risks muddying the waters on who possesses authentic voting power or control of a company.

International approaches to the inclusion of Cash-Settled Derivatives

According to the Explanatory Memorandum, the Exposure Draft is designed to bring "*Australia's market transparency requirements into line with comparable jurisdictions.*"[7] The FSC supports this aim and notes the similar regimes in the US and UK.

In the US, after a lengthy consultation process the SEC recently decided to continue to exclude Cash-Settled Derivatives from beneficial ownership disclosure requirements.[8] Under pre-existing US law, disclosure requirements remain where a Cash-Settled Derivative:[9]

- "*confers voting and/or investment power"* (or a person otherwise acquires such power based on the purchase or sale of a derivative security);
- "*is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements";* or
- "*grants a right to acquire an equity security"* (i.e. a physically-settled derivative).

The FSC considers that this approach reflects a proportionate compromise between achieving transparency and avoiding unnecessary expenditure of time, cost and effort. As such, the FSC recommends maintaining the current approach to the reporting of Cash-Settled Derivatives, at least insofar as it applies to low-risk entities such as fund managers and superannuation funds.

The FSC also notes the approach taken in the UK, where disclosure is required for Cash-Settled Derivatives but there are express exemptions for:[10]

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[6] MFA submission to the SEC dated 11 April 2022.
[7] Explanatory Memorandum, paragraphs 1.31 and 1.35.
[8] SEC *Modernization of Beneficial Ownership Reporting*, Release Nos. 33-11253; 34-98704 (10 October 2023) at pages 107-115.
[9] SEC *Beneficial Ownership Reporting Requirements and Security-Based Swaps*, Release No. 34-64628 (8 June 2011) at page 10.
[10] This list is derived from the EU's Transparency Directive (2004/109/EC as amended by Directive 2013/50EU), as transposed into UK law through post Brexit changes to the *Financial Services and Markets Act 2000* (FSMA) and the UK Financial Conduct Authority's *Disclosure and Transparency Rules* (DTR).
The financial instruments subject to notification requirements are set out in section 89F(1)(b)(iii) of FSMA and according to DTR 5.3.1R, provided they satisfy any of the conditions set out in DTR 5.3.1R(1)(a) or DTR 5.3.1R(1)(b).

- Non-voting shares;
- Traditional warrants;
- Convertible bonds;
- Cash-settled index options, futures and swaps, where the relevant issuer's stock is a component stock (if they fail the "substance" test);
- Index-tracking ETFs, where the relevant issuer's stock is a component stock (if they fail the "substance" test);
- Rights;
- Volatility/variance swaps; and
- Dividend swaps.

ASIC's discretion under the proposed section 608B(3)

The FSC notes that the Exposure Draft would confer on ASIC a discretion to assign certain derivatives a value of zero. We also understand from consultations with Treasury that owners of derivatives assigned a value of zero would not be required to report their ownership.

The FSC respectfully suggests that conferring power on ASIC to prescribe the reportable number of securities or the methods available to calculate the reportable number, creating a need to remove certain derivatives from consideration by assigning them a value of zero, will create unnecessary uncertainty for industry. In the case of large fund managers and superannuation funds, with a large volume of transactions across a large number of funds and jurisdictions, it is important to ensure that there is certainty which can be embedded in their system configurations, calculations and reporting processes.

The FSC therefore suggests it would be more practical if the legislation simply excludes particular kinds of derivatives from the requirements (or alternatively includes certain types). In the specific case of Cash-Settled Derivatives, the FSC notes its recommendation that Australia's current approach to the reporting of Cash-Settled Derivatives be maintained.

However, if this suggestion is not accepted, then the FSC recommends that the Exposure Draft should be amended to:

1. make it clear that where ASIC assigns a derivative a value of zero, the owner is not obliged to report their ownership; and
2. still remove index derivatives from the scope of the legislation, since the Explanatory Memorandum contemplates their exclusion.[11]

Physically settled derivatives

The requirement for a party in the bought position of a physically settled derivative to distinguish "*relatable derivative-based holding percentage*" from "*deemed physically settleable derivative-based holding percentage*" in their section 671B notices is problematic as that party would typically have no actual knowledge of their counterparty's hedging position.

The Explanatory Memorandum contemplates that a person in the bought position would become aware of their counterparty's hedging position or holding in underlying securities by the counterparty filing a substantial holder notice.[12] However, it is not clear how fund managers or superannuation funds in the bought position would know whether the counterparty to their equity derivative was holding

[11] Explanatory Memorandum, paragraph 1.81.
[12] Explanatory Memorandum, paragraph 1.57.

underlying securities as a hedge. This is particularly true where large companies file substantial holder notices on behalf of a group of related entities or associates.

Example 1.1 at paragraph 1.98 of the Explanatory Memorandum assumes the investor is tracking the interests of the investment bank via their substantial holding disclosure – however this is not always feasible and, generally, the counterparty will not wish to disclose their position to the buy side and may not have an aggregated relevant interest exceeding 5%. Further, even if the counterparty's relevant interest was included in a substantial holder notice, its particular relevant interest and hedge position for a particular physically settled derivative is not likely to be discernible amongst the relevant interests of all the other entities and associates included in the notice. This is also the case for exchange-traded derivatives, where RG5.171 contemplates that the person in the bought position should essentially deem 100% of their economic exposure of the equity derivative as their "*relatable derivative-based holding percentage*" under the existing subsection 608(8).

Other comments

Implications for platforms

The FSC also notes with concern that the proposed regime appears to require platforms to disclose their holdings in equity derivatives as if the platform operator or trustee is the beneficial owner of the derivatives. The FSC submits that since platforms are conduits for individual investors, they should not be obliged to report as if they are the owners of the underlying derivatives, and that requiring such reporting may create confusion as to who holds the securities. To the extent that any reporting is required, the FSC asserts that it ought to be undertaken by the actual underlying investor.

The standardised form of reporting

The FSC is supportive in-principle of providing ASIC with the power to approve the form in which substantial holder notices are lodged. We would like to be consulted to ensure that the form would be easily produced and replicated, noting that many fund managers and superannuation funds engage in a high volume of transactions and need to be able to systemise the production of reports.

Transition period

The FSC notes feedback from members suggests that many fund managers and superannuation funds would not be able to comply with the proposed 6-month transition period, due to the nature of the system upgrades and changes to operational processes which would be required. The FSC is informed by members that a minimum of 18-months would be necessary for large financial organisations to upgrade their systems across different business divisions.

The FSC notes that the Takeovers Panel gave market participants over 12 months to be prepared for the introduction of its revised Guidance Note 20, and the Exposure Draft would impose a significantly larger reporting burden.

Costs of compliance

The FSC reiterates that there are significant costs associated with the proposed disclosure requirements both involving the initial development and installation of new reporting systems as well as ongoing reporting obligations. The FSC considers that prior to any expansion of existing beneficial ownership reporting requirements, Treasury undertake an evidence-led process to ensure that the perceived benefits of such a scheme outweigh the likely costs to industry.

At this stage, the FSC notes its view that whilst any improvement to disclosure and transparency is welcomed in principle, the amount of operational change and complexity to generate information that will be only available to a select group (members, academics and journalists) means the costs of the

proposal set out in the Exposure Draft will significantly outweigh its benefits.

While the FSC supports the objective of combatting financial crime. It is important to acknowledge that fund managers and superannuation funds are low-risk entities: while they hold economic exposures to underlying equities, they are not at high-risk of perpetrating financial crimes. Perversely, if fund managers and superannuation funds are required to comply with the proposed regime, this may have the effect of distracting regulators by making higher-risk entities' disclosures harder to locate and assess.

The FSC is eager to work with Treasury to find pragmatic and proportionate ways to strengthen the Exposure Draft.

Conclusion and next steps

The FSC appreciates the opportunity to contribute to this consultation and looks forward to continued engagement with Treasury regarding the Exposure Draft as well as broader policy discussions regarding a possible beneficial ownership register. We would welcome the opportunity to meet with you or your team to discuss this submission, explore these issues in more detail and find ways to work together to achieve these goals.

To arrange a meeting, please contact Jack Morgan, Director of Policy – Investment and Funds Management at jmorgan@fsc.org.au.

Yours sincerely

Jack Morgan

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