Law Council
OF AUSTRALIA

Business Law Section

10 August 2018

Mr Percy Bell
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The Treasury
Langton Crescent
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By email: CIVreform@treasury.gov.au

Dear Mr Bell

Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2018 – Exposure draft (second tranche)

The Corporations Committee (**Committee**) of the Business Law Section of the Law Council appreciates the opportunity to provide this further submission in relation to the Exposure Draft.

This submission follows our letter of 18 July 2018, which commented on the first tranche of the Exposure Draft of the Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2018 **(Exposure Draft)** and the accompanying Explanatory Materials (**Draft EM**). This letter relates to the second tranche of the Exposure Draft which was released on 19 July 2018 (**Tranche 2**).

Our most significant observations on Tranche 2 relate to what it does not do, rather than what it does. Our concern is that the deadline for introduction of the Bill into Parliament may result in the legislation being passed without fundamental building blocks of the Corporate Collective Investment Vehicle (**CCIV**) legislation being sufficiently identified and on track to be put in place.

Reading the first and second tranches of the Exposure Draft together, the key concerns are around the two novel features of the CCIV:

- **the role of the sub-fund as the investment offering**, which is not yet fully recognised in the Exposure Draft in various contexts, including listing on financial markets, takeover laws, voting, changing the constitution and continuous disclosure (noting that a managed investment scheme (**MIS**) is treated separately for these purposes, despite also not having legal personality); and

- **the role of the depositary**, which in our view should be conceptualised as an independent custodian with a supervisory role, an approach which would (if adopted) resolve numerous difficulties with the depositary's role as set out in the Exposure Draft around cost and competition, efficiency, transition, the

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chain of liability and flexibility to change depositary, including when control of a sub fund changes.

The significant risk that this creates is that the CCIV regime may gain little traction in the funds industry, because it is missing the features that industry has clearly identified are necessary to make it work.

These include:

- facilitation of listing CCIV sub funds;
- appropriate application of takeover laws;
- removal of the prohibition on a CCIV acquiring shares in itself to allow cross investment and Exchange Traded Products (**ETP**) market making;
- the ability to make depositaries accountable on service and price by providing for their removal other than by special resolution; and
- an independence test for depositaries that facilitates competition while protecting investors.

The Government has recently emphasised the importance of competition in financial services by promulgating the *Treasury Laws Amendment (Enhancing ASIC's Capabilities) Bill 2018* which proposes to include in Australian Securities and Investment Commission's (**ASIC'**s) mandate consideration of the effect of competition within the financial system.

We are also concerned that in some cases the drafting has a level of complication that means the policy behind the provisions is not transparently communicated to the businesses that will work with this legislation.

If Government gets the policy settings right, the CCIV could be transformational, and we encourage Treasury to undertake the additional consideration and drafting work to lay the foundations in the legislation required to make this happen.

The attached submissions set out the detail and reasoning of our concerns with Tranche 2, and in some instances link back to material in Tranche 1.

We would be happy to meet to discuss any of these points and to assist in helping to develop solutions to any problems. If you wish to discuss or have any questions or comments on this submission, please do not hesitate to contact Committee members David Eliakim (david.eliakim@au.kwm.com or 02 9296 2061) or Alan Shaw (alanjshaw@outlook.com or 0419 300 611).

Yours sincerely

Rebecca Maslen-Stannage
Chair, Business Law Section

Submissions on Tranche 2

1. Winding up

1.1 Specifying the sub fund in a statutory demand

We appreciate that sections 1249G and 1249H have been drafted to ensure that creditors who are not aware of the internal workings of the CCIV are able to sustain a claim for a debt owed to them by the CCIV in respect of a sub fund without having to specify the sub fund in a statutory demand. However, this may favour the interests of the creditor over the interests of investors in sub funds other than the sub fund in respect of which the debt is owed, at least until the allocation of the liability is corrected by a court dealing with the matter.

It should be possible to deal appropriately with the needs of both the creditors and investors by requiring the creditor to specify a sub fund and providing for a rebuttable presumption that the specification is correct. As currently drafted, these sections create at the very least the perception that investors in other sub funds may bear the liability.

1.2 Strength of the separating assumptions

We also understand the purpose and function of the "separating assumptions" applied to produce the regulatory and liability firewall of the sub funds a protected cells and agree with the simplicity of this approach on winding up of a sub fund.

We suggest that stronger language than "assumption" is appropriate to strengthen the perception of the protection it affords to investors in each sub fund. Referring to the four points as "separating rules" may be a better approach.

2. Chapter 7

2.1 Depositary providing financial services to retail clients

Section 1250C(2) effectively provides that a depositary is taken to provide financial services to the investors in the CCIV.

While it is appropriate for the corporate director to be providing the financial service of operating the CCIV to investors, the depositary holds the assets for the CCIV and so should only be providing financial services to the CCIV.

The current drafting means that depositaries would need to be authorised under their Australian financial services licence to provide services to retail clients. According to publicly available ASIC records, a number of the largest custodians in the Australian market – who might otherwise be expected to offer depositary services – are not licensed to provide services to retail clients[1].

To optimise choice, competition and pricing in the depositary services market, section 1250C should be amended so it only refers to the corporate director, not the depositary.

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[1] JP Morgan, State Street and The Northern Trust appear to hold licences limited to provision of services to wholesale clients.

2.2 PDS exemption for small scale offers

Section 1250R(6) provides that section 1012E applies to financial products that are securities in a CCIV. As explained in more detail in the addendum to our submission of 18 July, the 20 client and $2 million limits in section 1012E should apply separately on a sub-fund by sub-fund basis rather than cumulatively on a whole of CCIV basis.

This 20 client / $ 2million test is also applied to offers of shares in trading companies under section 708(1). We submit that the concept should be applied comparably across all shares and interests.

2.3 Licensing to operate a CCIV

Section 1250C(1)(a) provides that a corporate director provides a financial service if the corporate director "operates the business and conducts the affairs of the CCIV". This wording is not helpful for two reasons:

- no corporate director will ever operate a "business" – a CCIV is a passive investment fund which would lose its flow through tax status should it ever "carry on business" in the sense used in other provisions of the Corporations Act; and

- the equivalent authorisation in the context of managed investment schemes is that the responsible entity must be authorised to operate the scheme.

The desired meaning could be captured by the expression "operate the CCIV and each of its sub funds". This would eliminate the confusion regarding the carrying on of a business and provide for interpretation consistent with the equivalent arrangement for schemes. The reference to "business" occurs in several places in the Exposure Draft where the licensing concept is reflected.

2.4 Operating a wholesale CCIV

Reviewing the licensing provisions in Tranche 2 with the corporate director provisions in Tranche 1, it is now clear that there is no provision for a wholesale CCIV to be operated by a company which is appointed as an authorised representative of a licensed corporate director.

Particularly for small wholesale trusts in the context of an emerging business, it is would be helpful to permit a special purpose trustee to be appointed under section 916A as an authorised representative of the holder of a licence with appropriate authorisations. The regime for responsibility of the appointor licensee for the services provided by the representative is well understood and could easily be applied in the CCIV context.

This change would line up with the treatment of managed investment schemes, and we submit that the policy relating to the level of protection required by wholesale clients should be consistently applied between managed investment schemes and CCIVs.

3. Listing, takeovers and continuous disclosure

3.1 AQUA and mFund

For the CCIV regime to be widely adopted by industry, the legislation should allow for all types of products that are currently structured as a MIS to be structured as a CCIV.

We do not see any impediment for issues and redemptions of shares in a CCIV sub fund to be settled through the mFund platform, if the definition of "Managed Fund" in Section 7 of the Australian Securities Exchange (**ASX**) Operating Rules is amended to include a CCIV.

In relation to ASX's AQUA platform, this will similarly require amendments to the definitions of Managed Fund (and Exchange Traded Funds (**ETF**)) in the ASX Operating Rules. To properly facilitate quotation of securities in all types of products comparable in nature to those currently quoted on AQUA, a further amendment will be required – to remove the restriction on a CCIV acquiring shares in itself. As we, and others, have proposed in prior submissions, section 1246H should be amended. A CCIV is a collective investment, not a trading company, and prohibitions on self-acquisition and capital reduction are inappropriate, other than where they may result in insolvency. The difficulty section 1246H creates in the AQUA market is that it will not be possible for the CCIV to undertake market making activities. As ASIC pointed out in its report 583 (*Review of exchange traded products, 2 August 2018*), it is important to the proper operation of ETPs that there be sufficient market-making activity to create a fair and orderly market. This includes "internal market making" as described at paragraph 98 of the report. ASIC's announcement with the report noted a concern with "market maker concentration" stating that most market making liquidity is provided by only two entities. Internal market making is therefore a desirable complement.

3.2 Listing of a sub fund on ASX

It is frequently the case that when a managed fund is established, the responsible entity will ask for provisions to make the trust suitable for listing on ASX to be included. If a good size and track record are achieved by the fund, listing can be an ultimate goal. The CCIV regime will be less attractive if provision is not made for this.

Quotation of securities on AQUA is not available unless the underlying securities are regularly and transparently priced, so that the issuer can publish net asset value data to facilitate investor action to minimise the spread between the trading price and the underlying value through applications and redemptions. This means that funds where the assets include private equity, real estate and infrastructure assets (for example) cannot utilise the AQUA platform, and to quote their securities, they must apply for listing on ASX's main board.

The Explanatory Memorandum for Tranche 2 states in paragraph 1.21 that "CCIVs will be prohibited from being listed on a prescribed financial market, but securities in a CCIV could be quoted on a financial market or settled using financial market infrastructure (subject to the rules of the relevant market). Listing of CCIVs will be considered further once the CCIV Regime is operating."

While it is correct that a CCIV would not be listed – it would be only a sub fund that would be the listed entity - this short-sighted approach of dealing with listing later threatens the attractiveness of the CCIV regime as a whole. We submit that, at least, no impediments to listing should be built into the architecture of the legislation.

For CCIVs to be listed, the Exposure Draft needs to be amended to provide for:

- *The application of takeover provisions to a listed CCIV*. The Explanatory Memorandum for Tranche 2 states that "CCIVs are intended to operate with a similar corporate structure to UCITS funds and OEICs. Relevantly, UCITS funds and OEICs are not subject to the requirements and regulations regarding takeovers in their corresponding jurisdictions." With respect, this is not the relevant point of reference – the comparison should be with listed managed investment schemes. A substantial amount of Australia's retirement savings is invested in listed trusts, including listed investment trusts, real estate investment trusts and infrastructure trusts, including as part of stapled structures. Functionally similar structures should provide equivalent investor protection. In the absence of takeover provisions, investors in a listed CCIV would not be able to share in the control premium in a takeover, and a bidder could acquire more than 90% of the shares in a sub fund and not have the benefit of compulsory acquisition provisions to complete the acquisition. The takeover provisions should apply only to listed sub funds, as they do only to listed MISs under section 604, and their proposed application should be the subject of exposure for comment.

- *A simple mechanism for transition of control of the sub fund*, similar to the change of responsible entity that occurs by special resolution when a listed trust is taken over. Once the resolution is passed and ASIC is notified, sections 601FS and 601FT provide for the assets of the listed trust to be vested in the new responsible entity. This means that transfers of assets, with associated stamp duty and other complications, are not necessary. With a CCIV sub fund, the mechanics are not quite as simple, but could involve a special resolution of members of the sub fund approving the redesignation of their shares as shares in a newly created sub fund of a different CCIV which would be nominated in the notice of meeting. Such a provision should not require major surgery of the existing drafting but could be contained to (say) a new section 1233Y. The assets and liabilities attributable to the sub fund would move to the new CCIV under a mechanism similar to proposed sections 1238T and 1238U in Tranche 1. The alternative approaches of requiring all takeovers to occur by company scheme of arrangement or insisting that a sub fund can only be listed if it is the sole sub fund of a CCIV, would be more expensive and far less convenient.

- *Amendment of the Listing Rules* to provide for a sub fund to be a "listed entity", noting that it is no bar to listing that a sub fund is not a separate legal person, because a MIS does not have that form either. The corporate director would be responsible for compliance with the Listing Rules, in the same way a responsible entity is in respect of a MIS. We suggest engagement with ASX at the earliest possible time to devise the necessary changes.

3.3 Concept of the sub fund

There are a number of places in the Exposure Draft where the sub fund is not recognised as the relevant structure, and the CCIV as a whole is designated. This applies not only to listing of sub funds and takeover laws, but also a range of other circumstances including:

- amending the CCIV constitution – it should be possible for the CCIV constitution to be amended as it relates only to a sub fund by a vote of members of that sub fund only;

- voting generally – approval of benefits, actions or changes generally should be by sub fund except in the unusual case that they relate to the CCIV structure as a whole;

- continuous disclosure – information about assets, liabilities and events pertaining to a sub fund will not be of interest to members of other sub funds, in the same way that members of other trusts operated by a responsible entity do not need to receive the information.

3.4 Disclosing entities

Clause 3.9 of the Tranche 2 Explanatory Memorandum states that if a CCIV is a disclosing entity as defined in section 111AC it will be subject to the continuous disclosure requirements in Chapter 6CA in the same way as other disclosing entities. The logical way to apply continuous disclosure provisions would be by sub-trust, as noted above. Section 111AC(1) makes the CCIV a disclosing entity if any of its securities are ED securities. CCIV shares would be ED securities under section 111AF if, in brief, they were issued under a prospectus to more than 100 retail clients. CCIV shares will be issued under a PDS, so the section is not applicable. The principles in sections 111AC(2) and 111AFA which deal with MIS interests would work more appropriately, as they refer to “interests in an undertaking” and a “class of managed investment products”, but of course they too do not apply to CCIVs.

We suggest that the principles in the MIS provisions be replicated so that each sub fund could be a disclosing entity if it (not the CCIV overall) exceeds the 100-retail client threshold.

4. Definitional concepts

4.1 Managed investment scheme

A sub fund of a CCIV will, on its face, have all the characteristics of a managed investment scheme as defined in section 9 of the Corporations Act – contribution of money to a pooled investment over which the members do not have day to day control, and where there is a plan of action, being the investment mandate. We submit that the exclusion in paragraph (d) which states that a body corporate is excluded from the definition of MIS does not mean that the separate pools of assets and investors which aggregate in the sub funds are excluded, any more than the pools of assets and investors in trusts operated by a responsible entity. In each case a body corporate (the CCIV or responsible entity) issues interests in a pool which is not a separate legal person. This is so despite the interest in a CCIV being termed a “share” while the interest in a scheme is usually a unit.

Although there is no direct legal authority supporting this proposition, there seems to be sufficient risk that a sub fund share could be an interest in a managed investment scheme that it should be expressly excluded from the definition in section 9.

4.2 Law design by reference to other provisions

The difficulties with sections 1250C(2) and1250R(6) noted above are examples of a broader issue with the extent to which Tranche 2 refers to and amends other specified provisions of the Corporations Act, rather than spelling out the applicable provision within Chapter 8B. Close scrutiny is required to ensure the cross-referencing method does not produce unintended results. There is an argument that in cases where a provision references multiple other sections, or imposes liability for an offence, the clarity of spelling out the integrated effect of the provision is warranted. This could be achieved by stating in the existing provision “This section does not apply to a CCIV” and then setting out the full combination of the existing provision and the new CCIV-specific content as a separate provision in Chapter 8B.

5. Depositary – drawing together comments on both tranches

In our submission of 18 July, we made a number of submissions regarding the structure and role of the depositary, including:

- a functional rather than structural test of independence should be adopted for the depositary, in line with majority international standards and in the interests of efficiency and competitive pricing of depositary services;
- it should be possible to change the depositary other than by special resolution of members;
- the depositary should not be required to be liable for its agents unless it has failed an appropriate standard of selection and supervision; and
- the depositary should not be required to check on instructions from the corporate director before they are processed but should be able to refuse to deal in certain circumstances.

In subsequent discussions we have come to understand that the reason for strict liability for agents of the depositary is the concern that there is otherwise no chain of liability to protect the investor. This, and all the other difficulties with the depositary structure noted above, could be solved by a simple shift in concept. The role of the depositary should be as an independent custodian with additional supervisory functions, and the legislative drafting adjusted accordingly.

Custody services in Australia are already highly regulated, with Class Orders [CO 13/1409] and [CO 13/1410] under ASIC Regulatory Guide 133 prescribing high standards and a chain of holding assets on trust and subject to prescribed contractual provisions. As industry has spent a great deal of resources on implementing these requirements across the last few years, it would be wasteful and unnecessary to scrap this and impose a wholly different concept of a depositary with a separate statutory role (akin to a duplicate responsible entity) to perform the asset holding and supervisory function. If the depositary is appointed under contract as the agent of the corporate director, the chain of liability is the same as for registered schemes. Only an additional layer of protection so that the depositary cannot be terminated for improper reasons, such as raising compliance issues with the corporate director, needs to be added.

Also, in the context of financial advice, ASIC and Treasury have commented that structural independence is not necessarily required to manage conflicts of interests (see submissions to Round 2 of the Financial Services Royal Commission, paragraph 38 of the Treasury submission and paragraph 13 of the ASIC submission).