ASIC

Australian Securities & Investments Commission

Investors' trust and confidence in managed funds

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CHECK AGAINST DELIVERY

Introduction

Good afternoon and thank you for inviting me to speak today. I am delighted to be at the annual AVCAL alpha conference. Today I will be focusing on investor trust and confidence in managed funds from the regulator's perspective.

Australia's financial system – indeed, any financial system – is built on trust: trust in financial institutions and their staff, trust in financial intermediaries and trust in the regulatory arrangements that underpin them.

A casual observer of the Australian financial system today would probably feel that the trust of Australian consumers and investors has been eroded. All of us have an important role to play in restoring that trust. Financial institutions and intermediaries need to foster a culture not just of compliance with the law, but of focus on the long-term best interests of consumers of financial services, including investors.

We are committed to improving our regulatory activities in the managed fund sector in the interests of promoting a better financial system generally because that produces better outcomes for investors in managed investments. Without better outcomes, trust will not be restored.

Today I will briefly touch upon the following issues:

- portfolio holdings disclosure
- revised ASIC guidance on the provision of custodial and depository services
- breach reporting to ASIC
- identifying sector risks
- governance and risk management expectations
- recent ASIC surveillance findings
- ensuring appropriate disclosure, and
- developments in the sector.

Portfolio holdings disclosure

The Superannuation System Review, the driver behind the Stronger Super reforms, considered that 'systemic transparency' is currently lacking in the Australian superannuation system. One of the key reforms to assist with transparency is that of portfolio holdings disclosure.

Disclosure of portfolio holdings information is aimed at increasing the transparency of what specific investments are being made by superannuation funds, which would enable members and analysts to better assess the level of diversification and risk in particular superannuation products.

Under the portfolio holdings disclosure requirements, website disclosure will need to include information that identifies each financial product or other property acquired in this jurisdiction, and the value of same, in which assets, or assets derived from the assets of the superannuation fund are invested in (s1017BB). This is designed to capture investments in (for example) managed investment schemes. On the current drafting there is no materiality threshold that applies to the disclosure, although provision is made for the regulations to provide that an investment in a financial product is not a material investment.

The obligation to publish portfolio holdings disclosure information is supported by 'look through' provisions which require the Registrable Superannuation Entity (RSE) to be provided with information from underlying fund managers about their investments (s1017BC–s1017BE).

Submissions to the Superannuation System Review, particularly by Morningstar, highlighted the advantages of portfolio holdings disclosure, including that: [1]

- it would create an information platform that would promote better analysis of superannuation funds
- implementation would create an alignment with global practice. Australia and New Zealand were the only two countries among the 16 assessed who did not require regular full portfolio holdings disclosure
- it would allow interested members to minimise overlap with their non-superannuation investments
- it would provide much greater transparency without significant cost or externalities
- the level of illiquid assets in a portfolio would be more observable
- it would not facilitate front-running (if there is a 60-day time lag before the information needs to be provided to APRA)

[1] See Super System Review, Final report: Part two, *Recommendation packages*, p. 123.

- it would discourage undesirable manager behaviour like excess turnover, and
- it would enable better monitoring of 'true-to-label' issues.

Industry concerns

We understand that industry's concerns with the portfolio holdings disclosure regime include:

- the requirement to publish commercially sensitive information, such as in relation to valuations of infrastructure and direct property
- the absence of any regulations setting materiality thresholds (although regulations may be made imposing a materiality threshold on disclosure)[2]
- the requirement to publish portfolio holdings of underlying investment structures through the 'look-through' disclosure obligation, and
- the possibility that portfolio holdings disclosure will turn trustees away from private equity investments or, conversely, that private equity investments will not be available to superannuation funds because of the portfolio holdings disclosure.

Criminal and civil liability offences apply in relation to breaches of disclosure of portfolio holdings information.

Current status

The portfolio holdings disclosure requirements have been legislated;[3] however, regulations giving greater specificity to the look and feel of the information on a trustee website are yet to be finalised. Early draft regulations in April/May 2013 included complicated disclosure tables that were heavily criticised by industry. ASIC also expressed concerns with the clarity of the disclosure in these tables.

The Government's commitment to enhancing transparency is now being considered in light of the Government's aim to reduce regulation and compliance costs.

The portfolio holdings disclosure regime has therefore been delayed by ASIC class order [CO 14/443][4] until 1 July 2015 for notification requirements, although the actual disclosure of portfolio holding information on a trustee website will not be required until 90 days after a first reporting

[2] The Treasury discussion paper seeks industry responses on the materiality threshold that could be applied to portfolio holdings, and suggests the materiality threshold in APRA Reporting Standard SRS 532.0 *Investment exposure concentrations* of 1% of the assets of the RSE as a possible threshold.
[3] See Tranche 3, starting at s1017BB of the Corporations Act.
[4] Class Order [CO 14/443] *Deferral of choice product dashboard and portfolio holdings disclosure regimes*.

date of 31 December 2015. The regime will apply next year to deals entered into now as the class order made no changes in this regard.

We think there will be a portfolio holdings disclosure regime in Australia – it's just a question of how it will be structured.

ASIC supports a portfolio holdings disclosure regime and the transparency it would bring, however:

- rather than 'look-through', we would be supportive of portfolio holdings disclosure applying to managed investment schemes as well (and trustees would refer to a scheme's website for further information); and
- we are not in favour of a materiality threshold, largely because our experience suggests that such a threshold provides opportunities for problematic assets to be hidden.

That said, of course these are policy matters for the Government to consider and decide, not ASIC.

Revised guidance on custodial and depository services

In November 2013 ASIC published revised Regulatory Guide 133 *Managed investments and custodial or depository services: Holding assets* (RG 133). In summary, RG 133 explains the measures that:

- apply minimum standards to asset holders for managed investment schemes and holders of financial products, and affects responsible entities (REs), licensed custodians, platform operators and managed discretionary account operators
- ensure agreements with asset holders have certain minimum terms, and
- require primary production scheme REs to safeguard the land on which the scheme operates.

The revised regulatory guide is the culmination of work that ASIC has undertaken over more than three years. RG 133 was originally issued in 1998. In July 2012, ASIC released Report 291 *Custodial and depository services in Australia* (REP 291) following a review of and consultation with the custodial industry. The revised guidance in RG 133 also seeks to improve custody standards and better safeguard investors' assets. The revision of RG 133 was completed after extensive industry consultation, including with the Australian Custodial Services Association (ACSA) and the Financial Services Council (FSC).

One particular change in ASIC policy in relation to holding of assets in custody may be of particular interest to AVCAL members. This is the

extension of the assets that an RE of a registered managed investment scheme can hold even if it doesn't meet the usual capital requirements for holdings scheme assets. This measure is designed to recognise practical issues in getting external custodians for some kinds of assets. These assets that REs without the usual capital requirements can hold are often referred to as 'special custody assets'.

Custodians and others we consulted informed us that it is sometimes difficult to ensure through agreements with the private equity managers that the custodian, as the asset holder on behalf of the RE, is not directly exposed to liability attached to the private equity investment. This is even though the custodian's role in the arrangement is to simply hold the private equity asset for their clients. The inability to remove the custodian's liability makes it harder for custodians to hold private equity in custody on behalf of their clients. In submissions we received on the revision of RG 133, industry requested that we extend the definition of special custody assets to include private equity investments that have a liability attached to them. We accepted this suggestion and similar submissions in respect of derivatives with a liability attached and certain types of bank accounts.

As you may expect, there are conditions that the RE will be required to meet in relation to special custody assets to help ensure the safety of these assets, including providing their custodian with regular information about transactions relating to these assets. The extension of special custody assets was made after extensive industry consultation and in response to submissions by custodians and associations representing REs.

Industry has indicated that – in the absence of this policy change – a number of REs may have been forced out of the industry, unable to find a suitable custodian to hold these assets on their behalf. Alternatively, it may have led to a substantial increase in custody fees.

Breach reporting

When breaches of the law occur, this can have a significant and detrimental impact on investors and financial consumers. Breach reporting forms an important part of the financial services regulatory framework, helping ASIC to identify and rectify problems with individual financial services businesses, as well as assisting us to identify and assess emerging risks and issues.

A key compliance obligation on AFS licensees, including REs, under s912D of the Corporations Act, is to report 'significant' breaches and likely breaches to ASIC within 10 business days. In addition, there are obligations on gatekeepers (i.e. compliance committee members and auditors) to report breaches to ASIC. Therefore, it is important for a licensee to ensure (and

gatekeepers to monitor) that there are adequate procedures to identify and record breaches, to ensure appropriate remedial action is taken and to notify ASIC of significant breaches and likely breaches. ASIC's guidance in Regulatory Guide 78 *Breach reporting by AFS licensees* (RG 78) can assist licensees in understanding and meeting this important obligation.

Because extended processes may defeat the law's intention for ASIC to be informed of significant breaches as soon as practicable, licensees should ***not*** wait until after the following events to send us a breach report:

- they have completed all possible avenues of investigation to satisfy whether or not the breach (or likely breach) is significant
- the breach (or likely breach) has been considered by the board of directors
- the breach (or likely breach) has been considered by internal or external legal advisers
- the breach has been rectified (when appropriate), or steps have been taken to rectify, the breach (or likely breach), or
- in the case of a likely breach, the breach has in fact occurred.

Once notified, ASIC seeks to work collaboratively with a licensee to ensure that the breach is appropriately rectified.

The type of regulatory response ASIC takes to a breach notification will depend on the particular circumstances, including the provision that has been breached and the seriousness of the contravention and its consequences. We strongly encourage licensees to proactively report to us significant breaches or likely breaches in accordance with their obligations rather than for issues to be identified subsequently through our surveillance work or complaints.

Identifying risk in the sector and passing it on to ASIC

There are a number of risks in the managed investments sector which threaten to undermine trust in the sector. These risks include loss of funds due to actions or misconduct of licensees, poor disclosure causing harm, gatekeeper failure, and failure to identify systemic, sector or entity-specific risk.

ASIC harvests intelligence and insights from internal and external sources to make assessment of areas of greatest risk and to undertake activities addressing those risks, within our resources, and subject to also completing ASIC's mandatory activities. ASIC has established an internal Emerging Risk Committee and an External Advisory Panel to assist us to be more forward-looking in examining issues and assessing systemic risks. Working with industry also plays a key role in understanding sector risks.

In undertaking proactive surveillance work, ASIC has applied a risk-based approach aimed at identifying those AFS licensees that exhibit characteristics associated with risks we have identified within the sector. Some of the licensee risk indicators can include:

- non-compliance with statutory lodgement dates for compliance and financial reports
- evidence of licensees experiencing financial difficulties
- related party transactions
- no breach notifications in the past few years
- complaints received by ASIC
- compliance history of directors, officers and responsible managers
- limited or no continuous disclosure
- complex products or assets that are difficult to value, and
- payment of distributions from sources other than profits or scheme earnings.

Governance and risk management – what ASIC wants to see

The more good governance practices grow and develop and entrench, the more consumers and retail investors can be confident in the institutions that manage, store and invest their money.

Complying with the legislative framework and ASIC's regulatory guidance is obviously important, but we recognise that good governance amounts to much more than an attention to compliance. We consider it is important for AFS licensees to have clearly articulated systems and relationships that underpin supervision, responsibility, and accountability in the funds management function. Importantly, because of the interconnectedness of managed investment schemes, REs, custodians, and superannuation funds that ultimately invest in managed investment schemes, these governance frameworks should operate to reinforce each other.

Clearly, risk cannot be eliminated in the financial system, especially in the business of funds management. Nevertheless, we consider a crucial part of the governance framework involves having risk management systems that develop structures, policies and processes to identify critical risks , maintain oversight of those risks, and ameliorate their potential consequences or likelihood. Among other things, this means having:

- adequate resources dedicated to risk management
- key staff who take responsibility for owning risks and developing processes to mitigate them, and sign off on monitoring those risks, and

- regular reviews of the risk management system.

While the Corporations Act requires REs to have adequate risk management arrangements, it does not define what 'adequate' necessarily means. In 2013 ASIC published Consultation Paper 204 *Risk management systems of responsible entities* (CP 204), which proposed guidance based on many current practices of REs of registered managed investment schemes, including:

- ensuring risk management systems comprise processes to identify, assess and treat risks
- ensuring these processes are suitable for individual business objectives and operations
- ensuring that risk management systems address all material risks, including strategic, governance, operational, investment and liquidity risks, and
- reviewing risk management systems regularly, and no less than annually, for appropriateness, effectiveness and relevance to individual businesses.

Awaiting the Financial System Inquiry process, we have not proceeded to publish final guidance; however, risk management is an important area that continues to be relevant in the course of our surveillance work.

ASIC does have powers to require provision of risk management plans and explanation of how they are adequate, and we will use those powers when appropriate. REs should therefore keep their risk management arrangements under review to meet their regulatory obligations, their responsibilities to clients and their self-interest.

Our surveillance program and areas where we have identified issues

ASIC undertakes proactive and reactive risk-based surveillance of REs and disclosure documents to identify and mitigate material non-compliance and to set and maintain standards.

Some recent examples of this surveillance work are:

- our review of disclosure by REs of unlisted property trusts and mortgage schemes, and
- our review of fee and costs disclosure practices in the superannuation and managed investment industry.

Disclosure by REs of unlisted property trusts and mortgage schemes

Our review of disclosure by REs of unlisted property trusts and mortgage schemes found that REs failed to adequately address the benchmarks we have put it place to improve investor awareness of the risks of investing. REs also failed to provide the information in a single location on their website and/or in a single designated document. When REs aren't adequately disclosing those risks, investors are put in a vulnerable position. We will be liaising with industry to discuss our concerns and to follow up on compliance.

In particular, we held a roundtable with representatives of the property fund industry just last week and agreed to pursue actions to improve awareness and implementation of the benchmarks. This was a very positive example of the property fund industry's willingness to improve disclosure.

Fee and costs disclosure practices in the superannuation and managed investment industry

Our review of fee and cost disclosure practices in the superannuation and managed investment sector identified a number of issues, including non-disclosure of fees and costs relating to investment in underlying investment vehicles, incorrectly disclosing fees net of tax (by superannuation funds), and inconsistent disclosure of performance fees and other fees.

We released Report 398 *Fee and cost disclosure: Superannuation and managed investment products* (REP 398) to provide guidance on our findings and our views on appropriate disclosure.

We have commenced working with industry to improve fee and cost disclosure more generally. In particular, we will soon be publicly consulting industry on some technical modifications to some of the key fee and costs disclosure requirements in the Corporations Regulations intended to clarify these requirements and help increase consistency. We also intend to release an updated Regulatory Guide 97 *Disclosing fees and costs in PDSs and periodic statements* (RG 97) by the end of the 2014–15 financial year.

We have also held initial discussions with industry about the development of industry standards to complement ASIC guidance and the regulatory requirements. We consider that industry standards, which were flagged in Report 398, can further assist in improving disclosure practices and consistency. We will be having further discussions with industry, with the aim of starting to develop these standards or guidelines after the completion of the technical modifications mentioned earlier.

Ensuring appropriate disclosure

One of ASIC's strategic priorities is ensuring confident and informed investors. An area of significant focus for ASIC is advertising. Investors and financial consumers can be heavily influenced by advertisements for financial products and services. Advertisements that do not fairly represent a product or its key features and risks, or the nature and scope of services, can be misleading and create unrealistic expectations that may lead to poor financial decisions.

ASIC conducts proactive reviews of advertising materials of REs and superannuation trustees/administrators to ensure compliance with legislative requirements and ASIC guidance. In the current environment, advertising can take a variety of forms, including social media.

Key issues we have identified in relation to the content of the promotional materials by licensees include:

- unbalanced representations, including an overemphasis of product benefits
- prominent use of headline rates without appropriate risk disclosure
- inappropriate use of investment periods to artificially improve performance figures
- inadequate risk disclosure, and
- inappropriate product comparisons.

We will continue to regularly review advertisements and promotional materials with the aim of improving standards more generally within the wider industry.

Developments and opportunities

Finally, I would like to highlight some recent developments and opportunities for participants in the sector:

Asia Region Funds Passport

We are very aware of the desire by many in the asset management industry to export their services, given that we in Australia have a large base of assets under management and a substantial track record.

ASIC supports reducing the regulatory burden of complying with multiple regulatory requirements arising from Australian and foreign regulation where appropriate. Regulatory Guide 54 *Principles for cross-border financial regulation* (RG 54) sets out ASIC's current approach to

recognising overseas regulatory regimes for the purpose of facilitating cross-border financial regulation.

The Australian Government also strongly supports efforts to reduce regulatory burden and, in particular, the development of an Asia Region Funds Passport, an APEC initiative that aims to create a regulatory arrangement for the cross-border offer of collective investment schemes in participating economies. The passport will enable fund operators in passport member economies to offer eligible schemes to retail investors in other member economies under a streamlined process.

The passport working group (Australia, Korea, New Zealand, the Philippines, Singapore and Thailand) released a consultation paper in April 2014 to seek views from the public on the details of the proposed arrangements. The consultation period recently closed and responses are currently being reviewed.

Following this consultation, economies that decide they want to be passport member economies will work to finalise the arrangements by early 2015 with a view to the passport commencing in 2016. ASIC continues to support Treasury in the development of the Asia Region Funds Passport proposal.

mFund

mFund is a recent facility jointly operated by ASX Ltd and ASX Settlement Pty Ltd where requests for the issue or redemption of interests in unlisted and unquoted simple managed investment schemes can be made and holdings recorded through CHESS. This process seeks to make the process of acquiring and disposing of interests in simple managed investment schemes more efficient and lower operational costs for the investment management industry as a whole.

To facilitate the launch of mFund, ASIC has:

- issued class order relief in Class Order [CO 13/1621],[5] which exempts REs of simple managed investment schemes that use a Short-Form PDS available through the mFund from only issuing interests in response to an application form that was included in or accompanied a PDS. Instead, REs will generally be able to issue on the basis of an electronic message through the mFund indicating that the investor has been given the current version of the PDS by another AFS licensee, typically a broker
- exempted ASX and ASX Settlement from requiring an AFS licence for operating mFund. ASX already has an Australian market licence and ASX Settlement has a Clearing and settlement facility licence.

[5] Class Order [CO 13/1621] *Exemption and declaration for the operation of mFund.*

Conclusion

Australia's superannuation system provides a great opportunity to safeguard and improve the wealth of every Australian. This opportunity brings with it a great responsibility on investors to make sound investment decisions, but also on industry participants and regulators to provide a safe and competitive financial system that investors can trust. We need to work together to restore that trust.