ASIC REP 384 Complex Products
Submission by Richard Wilkins

Introduction and summary

I applaud ASIC for establishing the Complex Products Working Group in July 2012: specialist and continuous regulatory attention to this high-risk field of investment is vital. I note the Government's moratorium on new financial regulation. It appears that ASIC therefore intends to deal with the CP work through industry discussion and trying to strengthen investor awareness, rather than by proposing legislation (or even regulation). That approach might be insufficient, given the strong defensive lobbying to be expected from the industry and intermediaries regarding any changes proposed.

In my submission, paragraph and page references are to REP 384 unless otherwise stated. I have used "CP" to denote Complex Products of all the types that Table 2 identifies. For simplicity, I include margin FX contracts in the term "CFD".

I have attached some Appendices which comment on specific ASIC documents that are relevant to the regulation of CPs.

As a rule, in an open dynamic market it is rare to be able to create a financial product that provides better than a random prospect of beating the standard range of risk-adjusted returns for its sector - unless the product can benefit from external arbitrage opportunities including tax concessions. It's therefore apposite to begin an examination of most categories of CPs from the position that- if a financial product purports to offer reduced risk and/or unusually high returns- there is likely to be inadequate information available to the buyer; risks or asymmetries are understated or not disclosed; and/or prospective returns are expressed in a way that is not commercially fair or mathematically rigorous.

As a dominant principle, regulators and investors should be sceptical, and ask the question- "why is the CP being offered to (retail) investors?"- unless it is raising capital for a third party business /primary issuer (eg preference shares or notes). If the product is derivative or synthetic, it is likely to be only a trading opportunity. Except in the case of genuine capital raisings, one would expect that- if the product truly provided an unusually attractive risk/reward relationship- the investment bank or other promoter would want to keep all such benefits for itself. The exception would be if there were external benefits such as regulatory capital arbitrage, or advantageous tax treatment that was available only to higher rate tax payers. Many of the product types discussed in REP 384 are likely to attract investors only because most buyers do not truly understand the risks, or what levels of returns ought to be expected for taking those risks, and the fees and costs involved are often not clearly and fully disclosed; these factors, if known, would shift the probability distribution of expected returns downwards by comparison with a simpler combination of the underlying CP components.

This general conclusion appears to be supported by the analysis referred to in the ESMA paper "Retailisation in the EU": the risk-adjusted returns of 2,750 retail structured products in various EU markets over a 14 year period were on average between 0.3% and 2.6% pa below the relevant risk free rates. The dispersion of the results was not stated- but was probably very wide- and I am surprised that the mean results were not even worse than their findings.

In most cases, it is likely that a CP has been designed largely for the benefit of the promoter/issuer- to generate unusually large fees or lending spreads, or obtain underpriced capital- rather than as a legitimate product that well-informed investors would rationally seek. The AFMA/ASIC principles in Para 59(a) are of fundamental importance to try to combat this; providing they are strictly monitored and enforced they would go a long way to mitigating the problems referred to above. Its paragraphs 6, 31 and 45 are most encouraging, namely:

"Should only offer a financial product that represents a genuine investment opportunity for investors"; "A sound business case should exist for the product, which is based on its capacity to satisfy what are expected to be genuine client demands" and "The product should satisfy what is understood to be genuine client interest, and management of the offering should enhance the firm's relationship with its investors".

The final sentence is enlightened: many issuers of CPs must have lost large numbers of clients through over-enthusiastic promotion of flawed or badly priced products. My highly critical comments here do not necessarily apply to all CPs—but they do to my own experiences with structured products and hedge funds (see App D).

To counter the problems of risk and return asymmetry, and insufficient investor understanding, the best approach to enhancing quality, transparency and investor protection with CPs (short of outright prohibition) is extensive surveillance by ASIC and much more emphatic investor education. This surveillance should be throughout <u>all</u> phases of the product cycle, and ASIC's recognition of this fact is welcome. This should be accompanied by clearer and tougher product warnings. Stronger penalties need to be available to deter contraventions. Most forms of CPs should be sold only through AFS Licensees. Advertising restrictions should be tightened.

ASIC's collaboration with AFMA is welcome and should be developed; the two IOSCO reports cited in REP 384 have many good suggestions that could be applied in the Australian market, including the Toolkit and Benchmarks approach. Indeed, much of the discussion in FR 01/13 on Suitable Distribution Methods for CPs could be used to improve Australian distribution practices for all financial products, not merely CPs.

FR14/13 covers "Regulation of Retail Structured Products" and therefore appears to exclude ETOs, CFDs, hybrids and of course agribusiness; however, many of its principles are also relevant to those CP categories. I welcome the fact that most of REP 384 appears to adopt the IOSCO suggestions and its approach, although in some instances REP 384 is more tentative than the IOSCO papers. IOSCO does not discuss or recommend whether investments in CPs should be subject to a minimum level (for example $50-$100,000), to prevent most retail investors from being drawn into CPs. Although such a restriction has some merit, it would unreasonably interfere with the free markets and could be counterproductive by encouraging investors to take much larger exposures, which they can't afford. On balance, I believe that investor protection is best served by qualitative means, such as higher standards on the sell side in all stages of the product cycle, and stronger warnings and investor education and qualification testing on the buy side.

<u>**REP 384 comments**</u>

I agree with the list of features in Table1. However, the indicators and degree of *complexity*—whilst important and appropriate – are not necessarily the most fundamental concern that regulators should concentrate on. I believe that the *intensity* of risk is the highest danger for investors, and the CP categories as a whole display widely different degrees of risk. Although the degree will vary with specific products, and there may be some overlap in the ranges of risks to the investor, CFDs are much riskier than the other types of CPs, because their leverage is so high. I understand it is usually at least 20: 1 but can be as high as 200: 1. I would rank the CP categories in descending degree of risk, as follows:

1 CFDs
2 Exchange traded option strategies (ETOs)
3 Hedge funds and warrants
4 Capital protected/guaranteed products
5 Agribusiness
6 Hybrids*

* I have ranked hybrids as the least risky in this list on the assumption that they are listed hybrids of investment grade, which is true of almost all of those shown on page 44 of REP 365. There have been other listed hybrids of lower quality that have caused substantial or total loss for investors, which I refer to in App B. Some of these, but by no means all, were discussed in paragraphs 56-67 of REP 365. Although I have placed hybrids last in the list above, I acknowledge that all hybrids do still have material risks for investors; however, in general they are less commercially risky than the other five categories.

Table 3 describes a comprehensive range of risks and ASIC's response and proposals for further work. It may also be instructive to distinguish the regulatory approach and risk analysis depending on the main income-earning feature of the CP and the motivation for the promoter. For example- lending type products where the promoter makes most of its return from an interest spread (CFDs and warrants); CPs where fees or brokerage will be the main return (option trading, hybrids issues and hedge funds- and in the case of hedge funds it will be mostly long-term asset management and performance fees, rather than upfront fees); and those products where the issuer would obtain most of its return through being a counterparty (eg agribusiness and capital protected/ guaranteed products).

Paras 3, 5 & 12 ASIC should intensively monitor the role of advisors in the distribution process, to ensure that they have sufficient knowledge and training to advise their clients (with particular understanding of *each* client's different needs and risk appetite) for or against investing in a CP. Advisors must treat each client separately- not as members of a target "class". One wonders how many clients raise the topic of CPs (other than listed hybrids from ASX top 50 issuers), rather than being directed towards them by their advisors or brokers. The IOSCO paper FR01/13 has many good proposals to improve distribution standards. I note in App B as follows: "Para 92 [of REP 365] ASIC's approach is pragmatic, but why not go further and apply other CP protections such as AFS Licensing to hybrids?"

Table 1 and Para 28 mention "inverse returns" – these are not discussed further in REP 384. I understand that such products are sold and traded on the NYSE, TSX and LSE - and perhaps elsewhere. I have not encountered them in Australia; although if they have been, or were to be, introduced, their extreme complexity and counter-

intuitive features would make them riskier than all the other CPs mentioned in Table 2 (except perhaps for CFDs, because of their extremely high gearing). Inverse return products appear to be completely artificial and synthetic; they might have a legitimate place in the hedging techniques of professional investors, but it is hard to see how they could ethically be promoted to retail investors. They would probably form a subset of the “complex managed funds” at the extreme end of the risk spectrum, and would appear to be ill-suited to all but the most experienced and numerate investors.

Does ASIC maintain a register of all PDSs and prospectuses, both closed and still current, with the capacity to search by product type, risks and other features? That would assist the process of risk-based monitoring.

Table 3 (Page 6) To assist debate, it would be helpful to know approximately what percentage by value of each category of CPs available in Australia is issued by / through <u>non</u> AFMA members to retail investors? AFMA’s role in quality assurance is very welcome, although I understand that it does not have powers of intervention or sanction.

Table 3 Part D Can *any* CP be issued without a PDS or prospectus (other than by using the >$500K exemption)? Do any types of CP meet the tests of being eligible to use the Shorter PDS format? One would hope not- although if the disclosure requirements were at least as informative as set out in IOSCO’s FR14/13, it might be acceptable in some cases.

The term ‘sophisticated investor’ isn’t mentioned in REP 384; this seems a missed opportunity. ASIC may wish to consider if there is merit in restricting some types of CP to sophisticated investors, and perhaps introducing a more subtle and better-targeted approach to the notion of sophisticated investors in the Corporations Act, rather than being based only on income and assets. The legislative framework of separating sophisticated and wholesale investors from retail is crude-based only on wealth rather than knowledge- and causes market gaps. I hope that the Financial System Inquiry will make recommendations on this, which inter alia ought to help the development of a corporate bond market. In turn, because of its expected simplicity and transparency, and the prospect of offering long term yields that are higher and less variable than bank deposit interest rates, a (retail) corporate bond market would fill a large market gap in Australia and offer a safer and cheaper investment alternative to CPs.

Table 3 Part D1 I strongly agree about inappropriate distribution channels –and note the valuable principles and suggestions in IOSCO’s FR01/13 report.

Table 3 Part D2 The suggestion of showing disaggregated cost and value is helpful in principle, but fraught with difficulty to specify how it should be done, and highly subjective. Item 10 of FR14/13 noted resistance from issuers on this point, which is unsurprising. Also, how is “risk-based” to be determined? Eg is it based on the size of the issue, size of a minimum investment, intensity of risk in the product, or other specific factors?

Table 3 Part D3 Can ASIC require advertisements to contain specific warnings, for example to say “this is a CP as defined by ASIC and that intending investors should read XYZ document/ website reference; it may be unsuitable for <u>most</u> retail investors because of its complexity and risk; and intending investors should not invest more

than a small proportion of their capital in this class of investments". Eg also the recommendation to obtain professional financial advice under the Complex Investments heading in Money Smart. See also App E on RG 234. However, the commentary in Table 1 of RG 234 gives too much latitude to the promoter. The tests should be based on reasonable, well informed and objective opinions. TV and cinema advertising for CFDs cannot possibly satisfy this test, nor the comment next to "film and video" in its Table 2.

Table 3 Part D4 The longer ASIC guides on Capital Protected investments, Infrastructure investments and CFDs are good—see my comments on these in Appendices F and G. The Agribusiness guide is good, but I have not commented on it further. The various notes on hybrids, read in aggregate are also helpful (see App B). ETOs, futures and options, and warrants don't appear to be covered in the same substantial depth with their own investment guides. That would be a useful focus of further ASIC work, in conjunction with industry. Other guidance notes on Money Smart are well intentioned, but some are too brief.

A major challenge is how can ASIC ensure that potential investors are aware that these tools exist (i.e. the Investment Guides and self-assessment tests)? Is there *always* a requirement to say in the PDS (and advertising materials) that prospective investors should obtain independent professional financial advice? Does ASIC require a checklist in the PDS, which must include, amongst other things, disclosure against the indicators in Table 1 and a statement of all relevant risks?

Table 3 Parts D and E I suggest that all CPs except listed hybrids must be sold to retail investors only through AFSL holders. In my App A I suggest, with reference to RG227: "In Para 43, and Para 38, I would change the emphasis to "not suitable for most investors". CFDs are likely to be dangerous for all but 0.1% of investors: the language should be strong enough to reflect that.

Table 3 Part E How is the "risk based" assessment to be determined? In depth investor self-assessment tools should be required for all types of CPs listed in Table 2, not just CFDs.

As suggested in both IOSCO reports, the PDS should include at least three realistic worked examples of base, upside and downside cases to help illustrate the likely return profiles. Moreover, any nonlinear, leveraged or inverse return characteristics should be clearly explained. This would at least mitigate the tendency of promotional materials to be "rose–tinted".

Table 3 Part F Regular post sale information is certainly needed, and often lacking in practice. The suggestion of monthly updates of NTA etc information by hedge funds in RG 240 is a good principle; all types of CPs should publish monthly* updates on their websites, although this should not preclude immediate publication of time-critical information. (*Listed hybrids could be exempted from this if ASIC was satisfied that the ASX continuous disclosure rules would sufficiently meet these needs). As different types of CPs would need different information, prescriptive rules would be unhelpful: ASIC and AFMA could jointly develop disclosure principles for the major CP categories to provide post-sale information criteria that were relevant and timely to clients. Issuers should provide an email alert facility for investors, and contact details. Promoters tend to lose interest in providing service to their investors after issue, once the fee arrangements have been locked in. Some CPs are very long

term investments but their creation and distribution are managed with only the short term fees and profits of the promoters in mind.

It is necessary to distinguish between artificial and structured products, that are manufactured by an investment bank or broker, and those that raise new capital for a third party issuer (eg a bank hybrid) where the issuer has a long term interest in maintaining engagement (and reputation) with its investors. Indeed, such hybrids and agribusiness may be the only type of CPs that have that characteristic.

Para 11 I agree with the comments made, but the difficulty of understanding extends to pricing, likely shape of the probability distribution of returns, and non-linearity.

The principles in IOSCO FR 01/2013 re distribution methods [cited in paras 20 and 101 of REP 384] are very useful but the paper covers only intermediaries [as they define the word], not producers or issuers. This suggests that it wouldn't cover advertising by the issuer as opposed to brokers.

Para 23 All three criteria are important: in (b) this is especially important if they go into administration.

Para 26 I agree- which is why both rigorous self assessment tools and impartial professional advice are vital. Industry consultation and adopting the IOSCO benchmarks would help raise expectations.

Para 28 Detrimental aspects should also include uncertainly of maturity dates, counterparty risks (indeed, identify who is the counterparty) and the quality of any sponsors' 'guarantees'.

Table 4 Agribusiness products: the PDS should discuss tax risk, the need for an independent professional tax opinion, whether a tax ruling has been obtained, and the consequences of not getting a ruling or failure to comply. Given the recent and highly damaging collapse of several forestry schemes- and uncertainty regarding ownership of the trees between investors, landowners and financiers, and litigation thereon- an agribusiness PDS should contain comprehensive discussion of these risks and the relevant case law. The ASIC guide "Investing in Agribusiness schemes" is good, but it does not warn strongly about the risks above. There should be more focus on insolvency of the *scheme,* not just the RE. Forestry schemes have required prepayments from investors which may cover several years' worth of agricultural work, but the investors' funds are not kept separately in a trust account. All these advance payments may be lost if the funds are mingled with the RE's funds (or its related parties), leading to a much higher risk of collapse. This appears to have happened at Gunns, for example. In the introductory material on Money Smart, and perhaps in the guide itself, it would be helpful to name the main MIS failures in recent years, and direct potential investors to doing their own research on these failures. As an investor in some failed forestry schemes, I would never again invest in agribusiness; the real case studies make sobering reading.

Table 4 ETO strategies. Does that include options traded on overseas markets? There appear to be no MoneySmart guides on ETO strategies, as opposed to single options (and futures) - is that correct?

Table 4 Hedge Funds It would be instructive to know how much of the $50.7B and $15.2B was *not* sold to professional, wholesale or sophisticated investors. See also my comments in App B regarding correlation and dispersion of returns.

Table 4 See my comments in App B. There are some inconsistencies in REP 365 regarding the size of the hybrids investors' population, and their average holdings More work needs to be done to establish accurate figures: it may be that the actual number of investors is well over 75,000. The commentary in 14-020 MR (and 13-220 MR) and Para 55 of REP 365 rightly raises the need for diversification -but the message may not be heeded yet by the majority of investors who are non-advised (and even perhaps by many of those who are, depending on the professionalism of the advice).

Tables 4 and 5 Leveraged products. A further major risk arises from pooling client money and insolvency risks, as discussed below. See also my comments in Appendices A and F on the ASIC guide on CFD investment and ACCC's consent to the CFD Forum application.

Paras 31-35 One important disclosure needed is whether the issuer or a related party is included in the product structure as a *counterparty* -as opposed to being only an arranger, where unrelated parties provide the products' components such as derivatives, options and guarantees. Also the fee arrangements should disclose how much, if any, of the fees and pricing (including option premiums) is paid (either upfront or during the life of the products) by those third parties to the issuer and its related parties, or to brokers and other parties involved in the distribution process. Pricing arrangements can be embedded- it's not only "fees" that need to be disclosed. The investors must be told the <u>total</u> costs and profit margins that are included for all the sponsoring parties. All the points in Para 33 are correct especially (d) regarding the opacity of pricing structures. It is hard to avoid the impression that this is deliberate, and that many CPs are created to favour the issuers and confuse investors.

Para 32 Was the question framed to refer only to people who had invested in CPs, or to the general investing public? I suspect it was the former, since I imagine that 99% of the public would never contemplate investing in CPs, except perhaps for bank hybrids. Even if so, the figure of 71% is worrying but unsurprising.

Para 34 The investor may also not understand the limited exit mechanisms (if any) before scheduled maturity, including the likely risks and cost penalties, and risk of involuntary changes in maturity dates or cash locks. The increased interest from IOSCO and AFMA should help illuminate these points.

Table 5 ASIC should do an updated health check on the CFD market (see REP 205), and handling client money per REP 316. See also Apps A and F. ASIC's comments on hybrids are well made; see my observations in App B. REP 365 did mention some of the failed hybrids issued in 2005-7, but there were several more that either failed totally or lost a large proportion of their invested capital. [See para 119 of REP 365: I agree but the ideal response is to know that ASIC will look at every hybrids prospectus. Re para 92 of REP 365: ASIC's approach is pragmatic, but why not go further and apply other CP protections such as AFS Licensing to hybrids?]

Has a health check been conducted on ETO strategies, or hedge funds (other than REP 370 which seemed to be concerned only with systemic risk rather than investors' risk)?

It is disturbing that CFDs are advertised on television and in cinemas: that is utterly inappropriate for such high risk products.

Paras 42 and 46 Comprehensive and prominent display of key information is crucial. The last sentence of Para 46 is fundamental: that is why there is a need to state prominently in the PDS and <u>all</u> advertising that the product is a CP, with compulsory links to appropriate parts of ASIC's website for warnings on risks, self-assessment tools, detailed investment guides etc.

Para 47 See my introductory comments- nearly all of the products (except perhaps hybrids) are predominantly designed with a view to issuer profits, and only a distant second place for investor returns. I suggest that *only* the most straightforward of CPs with a good prospect of price discovery (such as listed hybrids) would provide adequate *risk –adjusted* value to investors (and even they may not be fairly priced). The example quoted of the Goldman Sachs product is extreme—but even without such bad faith the risks of mis-selling and investor loss are abnormally high. This is hardly surprising when few investors have the skill to conduct a rigorous analysis, and high sales fees taint the distribution process. It should be compulsory to disclose all relevant material conflicts of interest. Issuers should include at least three well explained examples under different realistic circumstances eg base, bull and bear cases. See also my comments in App D and on Para 95. The PDS and all marketing documents should explain any performance fees that may be charged and whether they are subject to high-water mark/ clawback mechanisms.

Paras 48-52 I agree with the comments about the diminishing effectiveness of disclosure. The best way to deal with these matters is more, and regular, surveillance and early intervention by ASIC and any other relevant regulators. AFMA involvement would also be welcome. The process cannot be left to investors as "buyer beware" or to promoters and advisors (too much conflict of interest). The "if not/why not" approach is probably not suitable for CPs: although the explanations of "why not" would be understood by ASIC, their significance would be lost on many investors. The IOSCO Toolkit and Benchmark principles are a stronger approach.

Para 53 These are all important principles. As in Para 47, I would add a requirement to show worked examples of realistic base, upside and downside cases in the PDS and all marketing materials, preferably reviewed by an independent accountant or other finance professional, and an explanation of any features that could cause non-linearity or gearing of returns. The modelling is almost certainly done in all cases now—but is of little value unless it is compulsory to communicate the conclusions (and comprehensive explanations) to targeted investors (and intermediaries). IOSCO FR 14/2013 [Regulating retail structured products] is cited in Paras 53, 66 and 110, but the text doesn't directly address how ASIC would accommodate the IOSCO Toolkit suggestions. The definition on page 7 of FR 14/13 excludes CFDs, options, probably hedge funds, and hybrids; however, much of the Toolkit and 16 criteria would still be relevant, and they should be implemented as widely as is feasible in all types of CPs.

Para 54 -62 I support ASIC's commentary, but please see also my suggestion above for a compulsory product warning- stating at least that the product <u>is</u> a CP, has

potential for much higher risk and different features from ordinary shares or bonds (and obviously bank deposits). There should be a requirement to state prominently in the PDS that if the product fails or provides unsatisfactory returns you are on your own—no industry or government compensation funds will make good your losses.

Para 55 The phrase "all things necessary" sets a standard of perfection, and would obviously mean different things to regulators, investors, promoters and intermediaries. It is desirable but probably rarely honoured. This list should include "transparency" .

Para 57/8 This approach is too optimistic, in the case of CPs: surveillance at all stages of the product cycle is necessary, and early intervention is best.

Paras 59, 61 & 69. ASIC's collaboration with AFMA is welcome, as is that its code of conduct is compulsory for its members. The AFMA Principles are commendable; however, they appear to apply only to "retail structured products'. The context suggests that, like the IOSCO paper, the ambit is narrower than ASIC's list of CP categories. As far as is practicable, it would be desirable for their ambit to be extended to all CPs. Paras 2, 17 and 18 of the AFMA Principles refer to *new* products; that is the logical starting point, but there would be merit in reviewing products that are still in the market for their consistency with these objectives.

Although the principles set out in Para 69 are suitable, the behaviour of distributors is bound to be influenced by selling fees, which in most cases will be paid by the issuer - not the client for advice. I hope that ASIC would extend the warning in Para 69(b) to all CP distribution. Also, as noted above, I would hope that the IOSCO and AFMA principles would extend to all classes of CPs - not just structured products.

Section D Key points: as noted previously in REP 384, advertising and marketing materials are probably much more heavily involved in the sale and distribution of CPs than for simpler investments. There is a heightened risk that advertising of CPs is misleading or deceptive, even if not intentionally so, or at least unbalanced and selective. This risk is most pronounced in non print media: it is disturbing to see advertisements for CFDs on television and in cinemas: this should be banned.

Para 63 The third sentence is apt, subject to the critical qualification that the advisor has no conflict of interest. The most notorious examples of conflicted 'advice' have been in agribusiness and forestry MIS, but it's likely to be a widespread problem in the sale of other CPs which incur upfront fees.

Para 66 I would prefer the IOSCO principle of responsibility to be "required" rather than "encouraged"; that would be closer to the objectives in Para 59(a).

Paras 67/8 Although the legal analysis is no doubt correct, it doesn't sit comfortably with the issuer's obligation to do <u>all</u> things necessary….; the last sentence of Para 68 notes that this "would encompass considering appropriate distribution channels for its products". This is of some help, but the words 'considering' and 'appropriate' are weak and don't extend to <u>ensuring</u> that the channels <u>are</u> appropriate, still less that the behaviour and marketing involving those channels is suitable and ethical. It is clearly a grey area, but some strengthening of the chain of responsibility back to the issuer would be desirable: the distribution process is clearly being conducted (ultimately) on behalf of, chosen by and paid for by, the issuer, so it can't disclaim all responsibility

for the actions of its intermediaries. One hopes that the issuer is held fully liable for any advertising that is *direct* to the public through the media.

Para 71 The commentary is correct: at the least, investors may not understand the levels of fees and margins, which as fixed costs will have a material effect on the risk/reward profile. As an example of this, I found the disclosure of the funding and returns mechanism in the PDSs/ prospectuses of some of Allco's listed trusts to be almost incomprehensible, despite being a chartered accountant with a mathematics degree. It is disappointing that they apparently satisfied disclosure obligations.

Table 6 and Paras 72/3. This is crucial- if ASIC would see all CP disclosure documents before issue, ASIC can stop them if necessary. But Table 6 says that ASIC will not necessarily see PDSs, unless they relate to the products under S1015B. *Are CFDs caught by the phrase 'to be traded on a financial market' ?*The different treatment of securities and other financial products is inexplicable, and dangerous. Although ASIC is not responsible for the content of a prospectus, the very fact that it must be lodged with ASIC (and is likely to be scrutinised to some degree) gives investors some assurance. It is perverse that this gatekeeper approach does not apply to other financial products, especially in the case of CPs - where it is most needed. I cannot see that there is a public policy benefit, and considerable risk of harm, in having this distinction between a prospectus and a PDS. Although the requirements of S1013 are needed, they appear to be weaker than the corresponding Prospectus requirements. At least, I suggest that the PDS should contain worked examples of realistic base, upside and downside cases and explicit discussion of risks of any features like gearing (especially for CFDs) and non-linear returns. In the case of ETO strategies, the PDS should clearly describe the feature of the rapid decay of time premiums, which causes a much higher propensity for partial loss than most other forms of investments; this feature tends to require an active trading strategy to create trading profits to offset that amortisation. All PDSs, prospectuses and marketing materials for CPs should contain compulsory warnings, and website links to comprehensive ASIC investors' guides and self-assessment tools.

Table 6 refers to stop powers for a prospectus or PDS; and stop orders for the offer, issue, sale and transfer of 'securities'- it doesn't say whether the latter could be applied to non-securities products. Has ASIC ever permanently stopped any PDSs of CPs? In what circumstances would ASIC intervene to withdraw a PDS, so the product was only permitted to be sold to sophisticated or wholesale investors? The FCA's12 month stop power (Para 52) is a powerful incentive for compliance.

Para 78(b) The effort is worthwhile, but the approach seems haphazard, as Table 6 suggests that only a small number of PDSs would be lodged with ASIC. One would prefer surveillance pre- sale over post sale- or better still, to have both.

Table 8 As stated above, ETO strategies should disclose prominently the inherent financial risk of time-premium decay, usually over a few months or weeks, to zero value. This feature (and the very high gearing in CFDs and margin FX trading) necessitates a much more active investment strategy than with hybrids or agribusiness products, or even hedge funds. Any actual or potential use of sold put or call options should explicitly warn about the asymmetry between premiums received and potential losses if the options are exercised against the investor. Likewise, all strategies that involve short selling- eg CFD margin FX and uncovered sold call options- should have their potential for infinite losses highlighted. Although most hedge funds are

likely to employ several strategies simultaneously, ASIC could consider requiring special warnings for those hedge funds where a substantial proportion of the expected activity (say over 30% by value) is some form of short selling. The PDS should also state whether there is any risk that an investor could have liability (eg in a partly paid or trust structure) for losses beyond his entire *initial* capital. Any examples given for ETO strategies should include realistic allowance for brokerage; many media and promotional articles provide persuasive and selective examples of rapid profits, which would be heavily eroded by fixed price brokerage. That comment may also need to be applied to CFDs.

Table 8 Hybrids. The hybrids on page 44 of REP 365 were all investment grade, by large and financially sophisticated issuers, except perhaps for 2 stocks. It is alarming that ASIC found that changes were needed even by issuers of this calibre.

Para 80 I agree, and also they downplay fees, costs and margins, and asymmetric risk/reward patterns. See also my comments about RG 234 in Appendix E.

Para 81 I agree. See my comments in App C about para 185 of REP 340, which stated "the advertising and promotion of financial products generally can have a significant impact on consumers' decisions to invest. Retail investors often do not read or understand the full PDS, tending to rely on shorter and more engaging marketing materials instead" Although the context was capital protected/ guaranteed products, this statement is no doubt true of all CPs.

Para 82 See my earlier comments on Paras 26-29 and 63-69. In the last sentence I would insert "all" before "advertising".

Table 9 The maximum penalty shown ($13,200) is far too low, and I suspect that that comment would apply to other penalties. I welcome ASIC's recent REP387 on the inadequacy of penalties.

Table 9 "ongoing". It is disturbing that such high profile issuers needed to be told to make amendments or withdrawals.

Para 86 See my comments above on Table 3 Part D4 and in Appendices F and G.

Paras 90-92 Research reports have often been compromised by conflicts of interest— notoriously so in agribusiness and forestry MIS- to the extent that they are of little use except perhaps to elucidate some of the project features. Has ASIC ever penalised a research house?

Para 94 The obligation to do <u>all</u> things necessary is desirable, and very demanding— but may be rarely met. This is obviously impossible to define in legalisation, so the most pragmatic approach is to have stringent surveillance by ASIC at early stages of the product cycle to explain what standards are expected. My impression is that, in general, no party in the issuance and selling chain behaves with complete objectivity, but the most conflicted are the brokers selling to their clients, but whose fees are paid by the issuers of the product. The introduction of the AFMA Principles should be supported throughout the finance industry, and not restricted to structured products.

Para 95 The suggestion of providing an unbundled cost analysis is very good; even though there will be practical problems and subjectivity, and industry resistance, any

effort on this point would usefully shine some light on the risk transfers and pricing structures. AFMA could assist with providing guidance on some ways of doing this. From personal experience I think that the issue premium estimates of 4.6% and 5.5% averages (in the ESMA "Retailisation" Report) are accurate, although the total effective costs could be higher still, depending on the extent of leverage or options embedded in the product. From the context, I infer that the figures referred to are only up-front costs. There are usually (always?) annual fees or costs in addition (even if not always well disclosed), which are higher- sometimes much higher- than would occur with simple investment products.

The conclusion of the ESMA14 year analysis is not surprising—it would be useful to see a graph of what the *dispersion* of returns was, and by how much the mean and standard deviation of the 2,750 sampled were below those of risk free investments.

Para 96 states "There is some contention"- by whom? I suspect that it is brokers and issuers who are claiming this. I believe that it would be useful to *impartial* advisors, and probably most clients. If such information is not useful to an individual investor, then the investor should not be contemplating buying the product. Even a highly experienced investor would find that this information would illuminate his understanding: if an investor would not find it useful, that would indicate that the investor had a seriously inadequate understanding of the product and its market context. This "contention" should be tested further—if brokers and issuers truly believe it to be the case, it means that they are actively promoting products to people who, in the main, have little or no prospect of understanding them- unless they were to use a well informed and independent financial advisor, and perhaps not even then. One wonders how such promoters could consider that they are behaving ethically, even if not contravening the law. My experience is that, even for a well-informed investor who knows the right questions to ask, brokers may not have the answers to these questions (or if they do, they may not understand them and are just using a summary provided by the issuer). In one case the issuer agreed that my interpretation of the (undisclosed) hedging structure used to synthesise a degree of portfolio 'protection' was correct, but refused to provide me- as an intending investor- with any figures on those embedded option costs.

Also, paras 55 and 57 of RG 234 on disclosure of fees and costs are especially pertinent to CPs, and applicable to PDSs themselves as well as advertising material. If the product has more than one tier in its ownership structure (eg a 'feeder fund' used to enable retail clients to invest in private equity, infrastructure and hedge funds) the fees and costs should be shown for all levels in the structure, to give the investors a complete understanding of the costs involved. Although this is not within the scope of REP 384, I am not convinced that this always happens with multilevel super fund management regulated by APRA.

Table 10 is useful and I urge much more surveillance at all stages of the distribution process. It is alarming that fewer than 10% of the hybrid investors took *personal* professional advice: I expect that most of them relied entirely on advertising by the issuers or marketing materials prepared by (their) brokers, and the strength of the issuer's "name". Both of the former tend to be more optimistically biased than the relevant prospectus/PDS. See also the schedule of listed hybrids on page 44 of REP 365: some commentators suggested that institutions rarely invested in them because their issue yields were below the equivalent rates in wholesale markets, and so retail investors were targeted as being less well-informed on market conditions and pricing.

[As noted in REP 365 Para 36, this argument seems plausible: after the disruption to the wholesale funding markets during and following the GFC dissipated, the banks could readily raise wholesale funds, even though spreads took longer to narrow. The fact that they were willing to go to the much greater effort and expense of targeting retail investors indicates that retail investors were willing to accept lower yields and/or much longer tenors than were available in wholesale markets.] The hybrids were thus marketed almost exclusively to retail investors for their attractions of franking credits, and yields well above those on bank deposits, but the marketing understated the subordination and other risky features. I would not go so far as to say that this was deliberately misleading, but the fact that institutions largely did not invest in those issues suggests retail investors were allowed, perhaps encouraged, to form a naïve and positively-biased view.

Structured products –ETOs. See my earlier comments regarding the need for prominent disclosure of the rapid decay of time premiums, and the risk of sold option strategies (or short selling by retail investors in general) which can in theory be infinite in some cases, unless closed out by a counterparty or market maker.

Paras 100-7 The level of non-advised sales, which appears to be high for some CPs, illustrates that a prominent risk warning should be required both in the prospectus/ PDS and intermediaries' marketing materials. Self assessment tools are useful but fall a long way short of ensuring full understanding (and I accept ASIC's comments on behavioural economics). Investors need a strong statement of the major risks, including illiquidity, volatility, difficulties and delays in redemptions, uncertainty of maturity dates, subordination and insolvency risk, dividends stops etc and especially the risk of high gearing, whether embedded or explicit. A laissez-faire approach to CPs is unrealistic and places too much risk onto the ill-informed, greedy or unsuspecting investor. I agree with the proposal by IOSCO in Para 101. It may be going too far to say that all CPs (or at least all unlisted ones) should be offered only to wholesale and sophisticated investors- but this may eventually need to be considered for some CPs if the current system is not tightened. The supposition appears to be that most investors are either very well informed or have enough common sense to avoid complex investments. That hope is misplaced: marketing of CPs plays on people's greed and deters proper caution. Many CP investors need to be protected against their own ignorance and enthusiasm.

Para 104 There is a *very* high "risk that investors may acquire a product that is not suitable for them." See also my comment in App A "In Para 43, and Para 38, of RG 227 I would change the emphasis to 'not suitable for <u>most</u> investors'. CFDs are likely to be dangerous for all but 0.1% of investors: the language should be strong enough to reflect that".

Paras 105/6. The client qualification policy *should* be mandatory for CFDs, and this approach should extend to all CPs, with sufficient substance and rigour (and ASIC surveillance) to ensure that it doesn't become a box-ticking exercise. Since it is ASIC's view that such action does not constitute the giving of personal financial advice, it is not an onerous expectation to require of issuers (or brokers, if the sale is indirect).

Paras 108-110 I agree that poor post –sales communication is prevalent; investors can be left to languish in a disappointing or cash-locked product for many years, and receive inadequate support, reporting and market-making. My experience with one

issuer was that it was difficult to find even contact details for information or assistance, even though that CP was issued by a subsidiary of a large financial institution. As Para 108 says, investors in market-linked CPs are likely to need time-critical information.

Para 117 Given the universal use of websites nowadays, this information could be provided monthly, and any material event notified within 5 business days, or immediately if necessary (preferably via email alerts to investors). Para 117(a) should also include any guarantors.

R Wilkins ASIC Submission on Complex Products REP 384 - Appendices

References in all Appendices are to paragraph or page numbers of the relevant ASIC documents unless otherwise stated.

Appendix A CFDs RG 227

Para 3 It is alarming that most CFD investors do not take advice but rely on advertising and marketing material. Regular ASIC surveillance, product warnings and insistence on compliance with the seven benchmarks are therefore essential.

Table 1 The benchmarks are good but the "if not/why not" approach may be too soft- the balance may err too much in favour of Para 23(b). In particular, Benchmarks 1, 4 and 5 should be mandatory. In Benchmark 1, I would add financial literacy and risk appetite: and see Paras 37-42. In Paras 38 and 43(a), and Client Qualification in Table 3, I would change the emphasis to "not suitable for MOST investors". CFDs are likely to be dangerous for all but 0.1% of investors: the language should be strong enough to reflect that.

Para 27 The issuer should also disclose clearly the interest rates and margins that apply to both long and short client positions.

Paras 33, 35 and 45 on advertising. I agree with the text: ASIC should ban CFD advertising from TV and cinema, as that's clearly inconsistent with the benchmarks. The warning in Para 35 is vital, but should be more explicit- i.e. state that CFDs are a very highly leveraged product- often 50:1, or even more.

Para 42 I suggest that ASIC should require that the client use the virtual model for at least a month before being allowed to open an account for real trading; the virtual account shouldn't be restricted to easy or favourable examples.

Para 48 The word "instantaneous" conflicts with the good suggestion in Para 42.

Benchmark 3 The CFD issuer should explain the main types of business model as described in Para 25, and state which model it is using. Paras 56 and 57 need to be strengthened.

Para 54 As well as describing the "quality" of its hedging, the issuer should indicate the hedging percentages that would typically apply to the main types of its trades eg equities, FX and commodities.

Paras 63-66 Stress testing at least quarterly should be mandatory (and hence so should Benchmark 4). A summary financial statement (including the value of the issuer's capital base and liquidity resources) should be placed on its website with at least quarterly results, no later than 15 business days after the test date - with a copy to ASIC, to ensure that it is done.

Client money provisions

Benchmark 5 and Paras 67-75 The risk of pooling client money with that of other clients (which is also discussed in Paras 29(b), 65 and 71- 73, of RG 212) is fundamental**.** Given the high level of risk for an individual client arising from the pooling of client money, Benchmark 5 must be mandatory. It is unacceptable that a CFD provider would be permitted not to have such a policy: I can't imagine what reason could justify the non-existence of something so fundamental to clients' risk. Even when Benchmark 5 is adopted and followed meticulously, the individual client bears a high risk, depending on how extreme the exposures of the other clients are. I believe it would be preferable that the practice of pooling money be banned. I note the recent ruling by the ACCC in response to CFD Forum's application. There appears to be considerable disagreement in the industry about whether their Standards 7 and 12 are solely for the protection of clients, or anti-competitive as well; AFMA itself told ACCC that it couldn't reach consensus among its members on these principles. I am not qualified to express an opinion on whether their Standards, or the objections to them, are reasonable; however, from a client's perspective the banning of client money pooling would be highly preferred. Paras 74/5 of RG 227 seem to be at the heart of the objections to the CFD Forum proposal—that it will make returns on capital too low; that may be the case, but it would greatly reduce client risk.

Para 64 of RG 212 "There should be clear and prominent disclosure of the timing of these payments and the risks arising for the client". Indeed, but this is really only a minimum rule: the asymmetric treatment of margin positions described in Para 64 of RG 212 seems unfair and would exacerbate the risk for an individual client with an "in the money" position.

How often does ASIC test the second sentence of RG 212.68 "We consider that licensees should not use or withdraw client money from the client money account in purported reliance on s981D in anticipation of an obligation arising"? If ASIC does not do so, is this expressly required to be checked by the auditor for the compliance certificate?

Paras 19 and 75 of RG 212 note that the auditor's report must confirm compliance with the client money provisions; however, I understand that that is required only annually. Since the audit is the only safeguard for clients, unless the pooling method is proscribed - either by regulations or voluntarily- I believe that CFD providers should be required to produce an audited compliance certificate on the client money rules more frequently—perhaps quarterly, at the same as my suggestion for the stress testing report. This is a dynamic and very high risk industry, and operators must expect to be subject to a strict compliance and reporting burden. Clients do not enjoy the protection of a large mandated capital buffer of the size that bank depositors do (even ignoring the extra benefit of their Government guarantee).

Table 3 would need to be modified to reflect the suggestions above.

Appendix "Questions to ask" should include the margin call procedures.

I welcome the AFMA October 2012 Principles, and commend in particular Paras 19-25 on its Product Approval policy, Para 31 on the need for a sound business case, Paras 41-43, and Sections F and G.

Appendix B Hybrids REP 365

All the entities mentioned in the appendix to REP 384 are listed Australian companies. All but (perhaps) MYOB and Healthscope could be regarded as investment grade, even though the issues are subordinated or quasi-equity. Was that schedule the entirety of the listed issues over the period? Were all the issues during that period made to retail investors—i.e. not using the exemptions for sophisticated or wholesale investors?

Much of REP 365 concerns bank hybrids. That analysis and the warnings are necessary; REP 365 explains well the complexity and potential pitfalls of those particular hybrids because of APRA capital adequacy rules. It rightly notes that an issuer may have two or more hybrids on issue, that might seem similar (and have similar names) but have different terms or pricing. However, it would be good for ASIC to broaden the list of *corporate* hybrids which failed (either partially or with a total loss), to amplify the cautionary effect. These hybrids had trust deeds or other constituent documents that looked impressive, and contained reporting and compliance requirements, but in the end were found to be useless to protect investors. The involvement of well known corporate trustees was equally ineffective.

Para 6 and 35 If these approx 75,000 investors subscribed for most or all of the $18.3B issues on page 44, that would be an average investment of nearly $250,000 per person (in addition to any hybrids that they may have owned before November 2011). That would be at the limits of sensible asset allocation if the investors had financial of assets of (say) $2m each, but in many cases it may indicate excessively high concentration in this asset class - and thus poor advice or absence of it. Indeed footnote 9 suggests that over 40% of those investors had investible assets of under $1m. ASIC's further work and website tools should strengthen the warnings on concentration risk

However, the updated figures in Para 176 are inconsistent with those in paras 6 and 35, and the total on page 44. (The figures in Para 171 also appear to be inconsistent.) I.e. 75,000 investors x an average total investment in hybrids of $97,000= a total of about $7.3B, which is well below the $18.3B issued on page 44, even before adding hybrids that had been acquired before that period. Part of the discrepancy could be due to timing: the Investor Trends report in footnote 24 includes November 2012 in its title, even though dated March 2013, so it presumably excludes hybrids issued after November 2012. However, if one takes only the hybrids on page 44 up to the Caltex issue in September 2012, that is still $10.7B in aggregate-which represents an average of $142,000 spread over the 75,000 investors. Even if one makes the unreasonably conservative assumption that the investors held NO hybrids before the issues on page 44, that figure is well above the $97,000 average mentioned in Para 176. Because of the importance of this matter, and the large issuance *after* the closing date in the Investment Trends report, the exercise should be updated- despite the decline in issuance in the last 12 months. Hybrids are a legitimate and suitable investment for a wide class of investors, but there's at least a potential risk of large losses if a systemic problem occurs in the financial sector, for investors who are overweighted to that asset class. The figures give cause for concern that investors with under $1m of investible assets could have excessive concentrations in hybrids; a further survey should be undertaken with rigorous sampling techniques to discover

how serious the potential problem might be. (It may be that the actual number of hybrids investors is well above the stated 75,000). The commentary in 14-020 MR (and 13-220MR) and Para 55 rightly raises suitability and need for diversification - but the message may not be accepted yet by the majority of investors who are non-advised.

Para 15(c) I appreciate that the word 'promise' is not meant literally—but ASIC needs to be alert to such language used in prospectuses, and especially marketing material, to ensure that the reader understands that the risks that the 'promise' can't be fulfilled are not remote.

Paras 18 and 29-34 In November 2013, the AFR reported that non-financial companies have "turned their backs on issuing hybrids after the large number in 2012", because S&P changed its ratings methodology. At the time of issue, they thought that their hybrids would continue to be treated [forever] as 100% equity for ratings purposes; this change didn't directly affect the holders, but it immediately affected the issuers' gearing and cost of capital. The reduction in issuance predicted in Paras 33 and 34 has clearly come to pass.

Paras 30, 39 and 54 The accounting treatment is also relevant eg whether the accounting standards require the hybrid to be treated as equity or debt in the balance sheet. Intending investors must be careful when looking at the issuer's balance sheet to assess its capital strength, and its capacity to service interest and hybrid distribution 'obligations'. If the hybrid is issued by a subsidiary, investors must understand the extent (if any) to which its performance is guaranteed by the listed parent.

Para 56 These examples serve as a powerful warning: the change in expected maturity dates (whether earlier or later) bought about by external events may cause the product's yield to be inconsistent with the market yield curve, and hence could cause a fall in price- unless the issue terms provide for a yield adjustment.

Paras 40 and 56-67: "investor expectations and hybrid 'failures'". These are all valuable examples, as well as other complete failures not mentioned, such as Austrim Nylex notes, Evans & Tate notes, HIH hybrids and Babcock & Brown notes. In contrast, in the cases of (for example) the CPIPA hybrid and Davids' Convertible Preference Shares, the issuers didn't fail outright but their hybrids' convertibility provisions were severely constrained by collars around the conversion ratios. Thus below certain values of the ordinary share price, the hybrid holder would not get a full conversion at par value of $100, but sometimes much less. Even though those issuers didn't "fail", their hybrids were convertible only at material discounts to the face value.

Paras 59 and 62 Alas this is an understatement! The promised 'regular income' has long since disappeared, so the market price of the Elders and Paperlinx hybrids reflects not only their perpetual term but the likelihood that resumption of income payments is remote, if at all. There is obvious concern about solvency and liquidation value. The only material commercial value that these two hybrids have is strategic- they impose dividend stops on the ordinary shares and would (or should) receive better treatment than the ordinary shares in a takeover.

Para 74 This anecdote is disturbing. Even if the investors are wholesale investors, and buying on the secondary market, there would have been a prospectus for the primary issue. Does ASIC have power to ensure that in such cases advisers and intermediaries must make the investors aware of the prospectus, and perhaps require the investor to give a written confirmation to the advisor that it has read and understood the prospectus before buying in either the primary or secondary market?

Paras 80-92 The failed hybrids show just how hard it is for regulators to protect investors. I am not aware if there is any evidence that the prospectuses of these failed issues were deficient, or that disclosure was misleading. The failures need to publicised widely. It would be unfair to refer directly to these failures in the prospectus of another company; yet it is crucial that intending investors are aware of the number and extent of actual failures, rather than being given only a statement of the theoretical risks. Every prospectus or PDS for hybrids ought to contain references to the ASIC Money Smart guides and REP 365, and the guides in turn should give fuller accounts of these failures to serve as investor warnings. The different accounting treatments need to be explained to warn investors against a simplistic reading of the issuer's balance sheet and comparison with other issuers. The prospectus should also contain easily accessible links to material documents such as the issuer's latest annual report and the trust deed.

Para 92 ASIC's approach is pragmatic, but why not go further and apply other CP protections such as AFS Licensing to hybrids?

Sometimes hybrids are convertible *only* by the holder (into ordinary shares), but may be redeemable at the issuer's choice; thus there are asymmetric rights. PDSs/ Prospectuses and marketing materials must state clearly whether the *holder* has any redemption right or the only "exit" mechanism is to sell or convert into ordinary shares. Recent court cases on HIH's Converting Notes show that there are flaws in assumptions regarding convertibility, especially if the 'ordinary equity' entity goes into administration.

Investors should note that hybrids are sometimes issued by overseas subsidiaries or branches (eg in NZ) to take advantage of more favourable tax treatment. The ATO has taken action against some of these eg a CBA hybrid for claiming tax deductions in NZ but offering franking credits on the distributions; hence clear disclosures of tax issues and risks are needed.

Para 107 and elsewhere: ASIC's website materials should all emphasise that hybrids are always subordinated to senior debt and (usually) other creditors- but often do *not* have covenants to protect the level of gearing that ranks ahead of the hybrid—which can deteriorate after issue. Para 114 makes a good point about disclosing covenants on senior debt, but issuers are often reluctant to disclose this to the market - even when asked. The prospectus must explain whether *later* debt or hybrid issues could be made that rank *ahead* of the hybrid in question. It is crucial that the prospectus/ PDS clearly explain the extent of subordination, which can be fatal in insolvency. For instance, some listed notes were subordinated to <u>all</u> creditors- which could include any successful ordinary shareholder claims against the issuer under the "Sons of Gwalia" principles.

Para 107(g) I would dispute the word ‘typically’. It’s often *not* the case that interest on hybrids is (fully) cumulative and compounding if missed. Sometimes this is limited to making good only 12 months’ worth before the dividend stop may be removed. Eg see Elders and Paperlinx.

Para 119 I agree but the ideal response is to know that ASIC will look at *every* hybrids prospectus.

Para 141 The conclusion in the last sentence may be optimistic: how can ASIC ensure that that does not happen, especially as the majority of hybrid investments appear to be non-advised?

Para 199 This is true, but intensive ASIC scrutiny and high quality *commercial* disclosure, not merely meeting the minimum legislative disclosure requirements, are paramount to investor protection.

Appendix C Capital guaranteed/protected products REP 340

The important IOSCO paper FR 14/13 was published after REP 340 was issued; it may be worth updating REP 340 for that.

Para 7 The AFMA initiative is commendable; as far as possible its principles should be applied to other forms of CPs.

Paras 25/6 and 34-6 are very important.

Para 30 This is all apt, especially (e). I agree with IOSCO’s proposal that PDSs and all marketing materials should contain (at least) three realistic scenarios, including a downside case. See also Paras 202-4.

P32 I suggest that ASIC should require a statement in a PDS or prospectus for CPs whether the issuer has applied for a tax ruling on the product-or a professional tax opinion to explain why that’s not necessary. Investor protection would be aided by requiring a link in the PDS to the ASIC “get the facts” guide.

Table 2 I suggest that SPV issues should be prohibited in this context unless they have an AFSL.

Paras 49-51 on fees and opacity (and Paras 132-4). I strongly agree: see my submission and comments in App D.

Paras 52- 4 and Parts D and E. The proposals contained in the AFMA principles and the IOSCO papers FR 01/13 and FR 14/13 would, if implemented forcefully, mitigate many of these problems, but not eliminate them. Even if it is not feasible to incorporate them in regulation, their status should be enhanced from being merely voluntary; as far as practicable they should be promptly incorporated into ASIC’s Regulatory Guides.

Para 185 This states “the advertising and promotion of financial products generally can have a significant impact on consumers’ decisions to invest. Retail investors often

do not read or understand the full PDS, tending to rely on shorter and more engaging marketing materials instead." This is no doubt true in many cases, because of their legalese and often the financial contents are dominated by accounting information rather than commercial analysis. For these reasons, it would be very helpful to insist on links in the PDS/ prospectus to ASIC's website and the Money Smart guides.

REP 377 advice on structured products

This investigation raised a number of concerns which are likely to be applicable to other types of CPs. In particular Paras 9-14; 17, 20 and 30; and Para 62. The REP 377 exercise would be worth repeating more extensively, in the light of the AFMA principles and the two IOSCO reports.

Appendix D Hedge Funds RG 240 and REP 370

Does ASIC intend to issue a guide on "Get the facts" for hedge funds? Until such is available, it would be helpful to require a statement in the PDS that investors should read RG 240 to see what is expected and help educate themselves on the risks.

RG 240.
Para 8 & App A .Why does the number of interposed entities matter?

REP 370 Hedge Funds
REP370 is only about systemic risks, not risks for investors. Figure 8 and Para 26 say that the mean and median show strong correlation to the ASX 200; this is surprising, as many promoters argue that an attraction of hedge funds is that they bear low correlation to other asset classes and hence can be justified as adding diversification benefits to a portfolio. Also the graph shows that there is very wide dispersion, which is of concern but unsurprising. It would be interesting to have further rigorous research on this, to be able to compare the standard deviation or Sharpe ratios of returns of these hedge funds to those of managed equities funds. It would also be enlightening to graph the rolling 5 year returns, as many hedge funds can exhibit extreme variability of returns in consecutive years, or even quarters.

It would be worthwhile to survey a sample of the 97% of hedge funds which were *not* reviewed under REP 370- they may differ in asset composition/strategy and ownership.

Email
In an email exchange with ASIC in March, inviting comment, I was pleased to be told that ASIC intended to conduct further investigations of retail investors' experiences in the hedge funds (HF) sector. The following is an edited version of a confidential response that I made, about my own experience with HFs.

Hedge funds are a field of high risk and volatility, with often inadequate disclosure and limited understanding by potential investors. I agree that it's essential to canvass opinions from the retail investor market, to balance those of the HF promoters and wholesale investors including large super funds.

I expect that most retail investors who have already made hedge fund investments would largely share the jaundiced opinion that I express below. One hopes that most sensible people would now stay away from HFs, as the risk/reward balance is usually so unsatisfactory. I assume that ASIC is mainly concerned with the more exotic HFs, rather than long/short equity funds or mainstream funds like Platinum, that are in substance “normal” equity funds that just happen to do some shorting of currencies or indices (and occasionally stocks) to hedge their portfolio risk, rather than for speculative purposes.

I invested in the following products. Some combine elements of HFs and structured, supposedly “capital- protected” products. These comments reflect only my personal experience with a small number of issuers: as I said above, it would be useful for ASIC to canvass widespread retail investor experience in HFs to help inform policy responses and surveillance.

1. Three funds called ‘Stripes’. They were for periods of 5 to 7 years and each invested in listed equity indices. One was based on Asian markets; another on Emerging Markets and the third on European equities. They were all “long only”, but with a 40-60% synthetic gearing level to boost returns, which [purported to be] bounded by a collar through option strategies [the cost of which was not disclosed, but I suspect embedded extra profit margins for the promoters]. In the end I was probably lucky with these three HFs, as I did get all my capital back at maturity—but only one of them had an adequate return of about 7%. The other two made annualised returns of only 1 or 2%, which was very poor considering the illiquidity, length of time the capital was committed, and riskiness. They matured 3 or 4 years ago; if their investment periods had coincided more with the GFC the results would probably have been much worse.

2. A long/short Aust equities HF: this wasn’t geared. I withdrew after several years of poor performance, with a 20% loss. There were no major inherent failings, just bad stock selection.

3. Adelaide BRIC fund. It invested 50% in international REIT indices and 50% in synthetic indices of the 4 BRIC equity markets. There were two problems with this product—which had a 7(?) year life. The first was being launched near the market peak pre GFC- which of course hammered both REITs and BRIC equities. Secondly, and fatally, both segments were designed to convert automatically via stop losses into zero coupon bonds/swaps. Because the relevant markets fell sharply, the stop losses were triggered and the two portfolios converted into – in effect - 5 year bonds at low implicit interest rates. When the markets all rebounded, the investors in this product were frozen and lost all the subsequent upside, having suffered all the downside. I sold out of that HF early (for a penalty fee) after about four years with a 25% loss of capital and nil income, as there was no point waiting for the maturity date.

4. OMIP funds. These are pure hedge funds- unlike the others above that did at least bear some resemblance to standard asset classes. They invested entirely in two hedge “fund of funds” strategies. Their investment strategy was aggressive and high turnover/ volatility. They invested both long and short in dozens of commodities, currencies, equities, bonds, and other indices etc, and changed the components very frequently. I was fortunate with my timing. I invested in the first two funds that were

launched in 1997/8, and they did very well. I stayed in them for nearly 14 years, and overall they earned about 10-12% pa pre-tax (even after the very high fees mentioned below). However, there were often big monthly fluctuations in value. The promoters went on to launch about 20 similar funds over the next 10 years—with almost identical strategies, but I understand that those mainly earned mediocre to bad returns for their investors.

It is hard to generalise about any common themes in the above four examples. There are of course thousands of hedge funds around the world with different strategies. Most of my funds were largely or fully invested at the beginning—rather than gradually—so there was a big risk on the choice of start date. Most of my HFs had (much) higher volatility than standard ungeared equities funds (either Australian or overseas); they were much less liquid than listed markets, and charged high to very high fees. The typical fee structure for Wall St hedge funds was 2 % pa of the asset base irrespective of performance, plus 20% of the out- performance over a given benchmark—and sometimes the threshold was set too low. The problem is that it's a 'zero sum game': nearly all the funds are participating in the same markets. Thus the total investor base will pay typically 2% pa fees on all the assets, the successful HFs will charge 20% of the upside as well, but the unsuccessful funds will not give back 20% of their losses. This fee asymmetry means that the *aggregate* results of investors in all the HFs would be considerably over 2% pa worse off than instead buying the underlying markets, and with lower volatility. A few HF managers have achieved remarkable long term success, but I believe that most longer term returns would be mediocre or worse, especially when adjusted for risk.

As an extreme example of the fee problem: I calculated that the OMIP base fees (which were spread over three or four different descriptions to make the total percentage look less obvious) were about 6% pa—even if the fund lost money. It's certainly a case of 'buyer beware' with HFs, more so than for almost any other type of investment.

Appendix E Advertising financial products (and services) RG 234

The IOSCO paper FR 01/13 and the AFMA principles were published after RG 234 was issued; they are very helpful and it would be worth updating RG 234 to reflect them. Does RG 234 (also) apply to disclosure of fees and costs in PDSs for super funds?

Para 11 Is it certain that all the types of CPs are picked up by the list in Para 11?

Page 7 Table 1 I appreciate that RG 234 applies to the wide of range of products referred to in Para 11; however, as far as CPs are concerned, the sections on 'Terms and phrases' and 'Target audience' give too much freedom to the promoter, in "unless *the promoter is confident* that these terms will be understood by the audience" and "unless *the promoter has assessed* that the product is suitable for that class". The following principles are sound: "Advertisements for complex products that are only appropriate for a limited group of people should not be targeted at a wider audience; information about risks and any warnings should be easily understood by an average viewer on the first viewing of an advertisement and not undermined by distracting sounds or images." However, the commentary gives too much latitude to the

promoter. The tests should be based on reasonable, well informed and objective opinions. TV and cinema advertising for CFDs cannot possibly satisfy this test, nor the comment next to "film and video" in Table 2.

I suggest that all CPs except perhaps listed hybrids should be sold to retail investors only through AFSL holders.

Paras 44/5 and 116/7 are well made points. Perhaps CPs should be carved out of Tables 1 and 2, and specific reference made to these paragraphs, as the level of caution and responsibility needs to be much higher. See also Paras 105-9.

Example 16 The spirit of this should apply to all CPs, not only CFDs.

Paras 55 and 57 on disclosure of fees and costs are especially pertinent to CPs. See for example my comments on the different names of fees in the OMIP products in App D. If the product has more than one tier in its ownership structure- eg in private equity, infrastructure and hedge funds- the fees and costs should be shown for all levels in the structure, to give investors a complete understanding of the costs involved. I am not convinced that this always happens with multilevel fund management arrangements for alternative asset classes in APRA- regulated super funds.

Appendix F ASIC's "Thinking of trading in CFDs?"

This is a very useful guide. Can ASIC insist on the inclusion of a link in the PDS recommending that investors read this guide?

Pages 10 & 11 There is always a material spread between the interest rates received and paid on short and long positions which will make the implied symmetry in the example unachievable.

Page 12 I would add "and with money you don't have" to "your own money".

See my comments in App A regarding client money risk.

Page14 Make clear that the Fidelity Fund doesn't apply to unlisted CFDs.

Page19 "Depending on the terms and conditions of your agreement with the CFD provider, the potential losses are unlimited". This is a powerful warning, and it would be good to repeat it on page 2 of the guide.

Page 21 The list should add the need for *immediate* access to cash to meet margin calls, and explain that CFDs are not "investing"- they are essentially gambling.

Page 29 This should also mention interest received on short positions, but explain that there will be a material spread between the rates of interest received and paid.

Appendix G ASIC's Infrastructure investment guide.

This guide contains good tips. However, to ensure that they reach their audience, does ASIC require a warning in the PDS to alert investors to its existence and advise them

that the guide should be read in conjunction with the PDS etc? It would be prudent to read the PDS irrespective of whether one is buying in an IPO or the secondary market.

Pages 5 and 6: should emphasise that the value could fall *significantly* because of incorrect forecasts or other adverse events (because of gearing, which is a feature of most infrastructure projects and is often higher than in most ASX listed companies.)

Page 9 The suggestion is sensible, but of course the investors can't read 12 months' worth of prior information if it's an IPO. Why does it say "only listed entities need to lodge with ASIC" - what if the unlisted entity is issuing "securities"?

Page 12 and Benchmark 3 should extend the warning to say that you could lose more than your entire investment if the equity is partly paid eg Bris Connections.

Page 37 This should point out that it's extremely unlikely that returns and yields can be guaranteed (unless artificially and temporarily, by being paid out of the capital structure itself); also that there is no government backing or compensation if the investment fails.