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by email

Dear Mr Worsley

Consultation Paper 315 – Foreign Financial Services Providers: Further Consultation

1 Introduction

This submission is made by Herbert Smith Freehills in response to a consultation paper published in July 2019 by the Australian Securities & Investments Commission (**ASIC**) and titled “Consultation Paper 315 – Foreign Financial Services Providers: Further Consultation” (**CP 315**).

Herbert Smith Freehills is an international law firm with 27 offices located around the globe and which specialises in, amongst other things, financial services and financial services regulation. We regularly advise:

(a) foreign financial services providers (**FFSPs**) who provide a range of financial products and financial services to their Australian based institutional and superannuation fund clients; and

(b) Australian based institutions and superannuation trustees in relation to their investment management arrangements with FFSPs.

Given our experience of working with both FFSPs and their Australian clients in an increasingly global financial services sector, we would like to make the general observation that it will be important for these proposed Australian regulatory reforms to strike an appropriate balance between:

(c) the benefits of increased regulation; and

(d) the effect on competition in the financial services sector and the increased compliance and regulatory costs to FFSPs wishing to continue to provide financial services in Australia (which costs may ultimately be passed on to Australian investors or reduce their returns). If the CP 315 reforms were to become a barrier to entry or were to result in a reduction of the providers of financial services or the range of financial products or services available to Australian clients that would reduce client choice and may limit the ability of Australian clients to achieve their investment strategies and the level of diversification they desire.

We have set out below our feedback in relation to some of the specific questions you raised in CP 315.

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2 Responses to certain CP 315 proposals and questions

2.1 ***B1Q1: Do you agree with our proposal to provide AFS licensing relief to permit FFSPs to provide funds management financial services to professional investors (subject to the cap in proposal B3 and the conditions in proposal B4)? If not, why not? Please be specific in your response.***

While we understand ASIC desire to introduce the funds management financial services relief as proposed in CP 315 (**funds management relief**), we have reservations about its ability to be used in practice and concerns about the narrowness of its scope and some of the conditions imposed.

(a) **Scope of the funds management relief**

We agree that an important consideration for the funds management relief is preserving competition by ensuring that a diversified range of investment managers and investment products may be made available to professional investors in Australia (paragraph 33, CP 315).

In our view, to appropriately address this consideration, the scope of the funds management relief needs to be widened. Specifically we consider that the current definitions of 'funds management financial services' and 'portfolio management service' are too narrow because the categories of permitted clients are unnecessarily limited, which has the (we presume unintended) consequence of excluding a range of important wholesale client investors and their investment structures, particularly:

(1) **Feeder funds**. As you know, many Australian institutional investors (including large superannuation funds) often establish Australian domiciled feeder funds to make their investments in offshore funds, for example to quarantine potential liability or preserve their regulatory and tax status.

(A) Feeder funds will not themselves be a superannuation fund so will not meet paragraph (a) of the definition of 'portfolio management service'.

(B) Many feeder funds are not managed investment schemes because they have only one unitholder (the superannuation fund) so will not meet paragraph (b) of the definition of 'portfolio management service'.

(C) An Australian domiciled feeder fund will clearly not meet the proposed definition of 'offshore fund' so advice and dealing services provided in relation to interest in a feeder fund will not meet paragraph (a) of the definition of 'funds management financial services'.

(2) **Family offices**. A feature of the Australian financial services industry is the relatively high incidence of family offices, which are Australian based so again clearly will not meet the proposed definition of 'offshore fund'. While family offices typically control more than $10 million they may not be structured and operated as a managed investment scheme, in which case they also won't meet paragraph (b) of the definition of 'portfolio management service'.

(3) **High net worth investors**. For the same reasons, high net worth investors may not meet paragraphs (a) or (b) of the definition of 'portfolio management service'.

We request that:

(4) the definition of 'portfolio management service' is aligned with the definition of 'funds management financial services', ideally by expanding the categories of client to 'professional investors' more generally or as a minimum by inserting a new paragraph (e) into the definition of 'portfolio management service' (to reflect paragraph (e) of the definition of 'professional investor' ie *a person who controls at least $10 million (including any amount held by an associate or under a trust that the person manages))*; and

(5) the definition of 'funds management financial services' is expanded to contemplate investments in offshore funds or feeder funds.

(b) **The aggregate revenue cap**

We understand that FFSPs consider that the proposed 10% aggregated revenue cap:

(1) is complex and will be difficult to give effect to on an ongoing basis;

(2) carries a risk of uncertainty for FFSPs and their clients in Australia given that the cap is a condition to the availability of the funds management relief;

(3) requires FFSPs to make forecasts, which increases their regulatory (misleading and deceptive conduct) risk given the reversal of the onus of proof in relation to forward looking statements under section 769C of the Corporations Act, as recognised by RG 170;

(4) ultimately favours FFSPs in larger corporate groups who can more easily comply with a group revenue cap, which has the potential to limiting diversification and competition by smaller manager groups; and

(5) arguably should be a percentage of profit (rather than revenue).

We have set out our more detailed comments in our response to B3Q1 below.

(c) **Section 911D condition**

The funds management relief is proposed to apply to a "foreign company that is carrying on a financial services business in this jurisdiction *only because of the operation of section 911D of the Act*" (emphasis added) (**911D Condition**).

Under section 911D of the Corporations Act, an FFSP is considered to be carrying on a financial services business (and therefore must be licensed) if the FFSP engages in conduct that induces, or is likely to induce, persons in Australia to use their services.

We understand that the intention and effect of the 911D Condition in the draft instrument is that an FFSP could only rely on the funds management relief if the *only* reason the FFSP is brought into the Australian regulatory regime is due to the deeming provision in the 911D Condition. FFSPs would not be able to rely on the funds management relief in other circumstances, such as if they are otherwise engaging in activities that would amount to carrying on a financial services business in Australia (for example if the deeming provision in the 911 Condition is not triggered or relied upon).

In our view this limitation is unnecessary and unduly limiting, particularly as Australian courts have taken a more flexible approach to when an entity will be seen to be 'carrying on a financial services business in Australia' in recent years.

We believe that this limitation has the very real potential to:

(1) significantly limit the ability of FFSPs to rely on the funds management relief; and

(2) fail to preserve competition and ensure that a diversified range of investment managers and investment products are made available to investors in Australia.

We therefore recommend that ASIC considers deleting "only" from the 911D Condition and inserting (in substitution) "including".

2.2 B1Q2: Do you agree with our proposal to not provide relief in relation to the provision of a custodial or depository service on the basis that it is covered by reg 7.6.01(1)(k)? If not, why? Please be specific in your response.

We do not agree with ASIC's proposal to not extend the funds management relief to cover the provision of custodial and depository services for the interests or securities of the scheme.

(a) The provision of custodial or depository services is an important and integral component a fund structure for a non-corporate fund such as a trust or a limited partnership.

(b) Where an offshore fund does not adopt a corporate structure or provides self-custody by not appointing an external custodian, the offshore fund will hold its assets on trust for, or on behalf of, investors in the offshore fund and so may be providing a custodial or depository service to clients in Australia.

(c) We understand that the exemption in Reg 7.6.01(1)(k) would not be a sufficient Australian financial services licence (**AFSL**) exemption for such offshore funds as it only applies where an FFSP is acting as sub-custodian to a master custodian who holds an AFSL.

(d) We note that the passporting class order exemptions (eg *ASIC Class Order [CO 03/1100]* as extended by *ASIC Corporations (Repeal and Transitional) Instrument 2016/396* currently provide for an exemption in relation to the financial service of 'providing a custodial or depository service' which is consistent with our understanding that the exemption in Reg 7.6.01(1)(k) is of limited utility in practice.

If custodial or depository services are not covered by the draft instrument for the funds management relief, then non-corporate offshore funds will be at a competitive disadvantage (compared to corporate offshore funds where assets are not held on trust for investors as an incident of the trust structure). This runs the risk that the funds management relief will fail to preserve competition and to ensure that a diversified range of investment managers and investment products are made available to investors in Australia.

For these reasons, we recommend and request that the draft instrument for the funds management relief is extended to custodial and depositary services.

2.3 B2Q2: Do you agree with our proposed definition of 'portfolio management services'? If not, why not? Please be specific in your response.

As canvassed in our response to B1Q1 above, we are of the view that the definition of 'portfolio management service' is too narrow.

In addition to the requests made in parts 2.1(a)(4) and 2.1(a)(5) above of this submission we request that the reference to '*management of assets*', which is not defined and is unclear in its application, is removed and replaced with a reference to the usual Corporations Act categories of financial services (for example providing financial advice or dealing in relation to financial products).

2.4 ***B2Q3: Do you agree with our proposed definition of 'eligible Australian users' of portfolio management services? If not, why not? Please be specific in your response***

Please see our responses to B1Q1 and B2Q2 in parts 2.1 and 2.3 above.

2.5 ***B3Q1: Do you agree with our proposal to apply an aggregated revenue cap to ensure that the financial services provided by FFSPs under the funds management relief are provided on a limited basis? If not, why not?***

As noted in our response to B1Q1 in part 2.1 above, we understand that FFSPs consider that the proposed 10% aggregated revenue cap raises a number of concerns.

(a) **Complexity**

The cap is complex and will be difficult to give effect to on an ongoing basis, applying a 10% trigger at the entity and group level. Entities within the same group may be in different jurisdictions with different laws and accounting standards, and they may not have information sharing protocols in place which are adequate to facilitate the necessary group revenue calculations on a rolling basis. Further, in certain group structures, an entity may operate autonomously from the parent company and/or related bodies corporate, making such calculations practically very difficult.

Given these considerations we expect that the cap condition will be challenging from an operational and compliance perspective, both for ASIC as a regulator and the FFSPs as users of the funds management relief.

On reflection, we consider that this level of complexity is unnecessary and appears to be contrary to Commissioner Hayne's overarching simplification recommendation of "simplification of the law, so that the law's intent is met".

(b) **Uncertainty risk**

The fact that the cap is a pre-condition to the availability of the funds management relief and that a failure to continue to satisfy the condition will cause the relief to fall away carries a real risk of uncertainty for FFSPs and their clients in Australia.

The satisfaction of this condition is binary and there is no transition period – once the condition is breached, the relief falls away and there is no transition period to allow the affected Australian clients to transition to another FFSP or Australian manager. As a practical matter:

(1) changing managers takes time. A prudent and responsible Australian institution or superannuation fund would need to undertake legal and commercial due diligence on a short list of replacement managers and once a replacement manager has been selected would need to negotiate and document a new investment management agreement; and

(2) if there is a delay in replacing a manager, there could be an adverse impact for the Australian institution or superannuation fund (and the underlying investors) in relation to a failure to give full effect to the fund's investment strategy.

We request that ASIC considers amending the funds management relief so that the cap is not a condition of the relief but rather the cap is a trigger to a notification to ASIC, following which ASIC may investigate and if it is concerned in relation to the FFSP in question, ASIC may give the FFSP a reasonable period of notice to remedy the concerns or to cease its use of the funds management relief (which notice period would allow an orderly transition to a

new manager and for due diligence to be performed in relation to the new manager).

(c) **Regulatory risk**

As the proposal requires FFSPs to make forecasts, that increases their regulatory (misleading and deceptive conduct) risk given the reversal of the onus of proof in relation to forward looking statements under section 769C of the Corporations Act, as recognised by RG 170.

(d) **Competition impact**

Ultimately the application of the cap has the potential to favour FFSPs in larger corporate groups who can more easily comply with a group revenue cap, and has the potential to limit diversification and competition by smaller manager groups. A FFSP in a smaller group, potentially operating in fewer jurisdictions, would be more likely to trigger the cap by generating a relatively small amount of revenue compared to a FFSP in a large corporate group whose consolidated revenue could eclipse the FFSP's revenue.

We understand that many Australian institutions seek out smaller boutique FFSPs who may be regarded as 'best of breed' and provide a more personal, focused service.

We encourage ASIC to consult broadly on the cap proposal to ensure that it does not have unintended competition effects or result in a loss of diversification.

The uncertainty risk noted in part 2.5(b) above could also give rise to unintended competition effects.

(1) For example, if Australian institution or superannuation fund was looking for a new manager and its shortlist of new managers included a FFSP and an Australian domiciled manager who has an AFSL, would the risk that the FFSP may be unable to fulfil its obligations and meet the condition to the funds management relief, without notice and potentially for reasons beyond the control of the FFSP cause a prudent and responsible Australian institution or superannuation fund to disregard all FFSPs?

(2) If the Australian client's investment strategy calls for international investment exposures (eg US small caps) and the Australian client is not confident that it can source an Australian manager with the requisite level of experience and skill in relation to those international investment exposures, would the Australian client risk appointing a local manager or would it feel it needs to change the investment strategy and reduce the diversification of the investments?

(e) **Aggregated revenue as the measure**

We understand that some FFSPs consider that the more appropriate measure would be a percentage of profit (rather than 10% of the annual aggregated consolidated gross revenue).

We also note that smaller FFSPs would likely consider that the competition impact of the cap would be reduced for them if the cap was formulated as a percentage of FFSP revenue rather than a percentage of aggregated group revenue.

2.6 ***B3Q4: Are there any other caps that we should consider as an alternative (see Table 3 for other caps we have considered)? What are the costs associated with monitoring compliance with your alternative cap? Please be specific in your response.***

Please see our response to B3Q3 in part 2.5(e) of this submission.

2.7 ***B4Q1: Do you agree with our proposal to impose these conditions on the funds management relief? If not, why not? Please be specific in your response***

Please see our response to B1Q1 in part 2.1 of this submission and our comments in relation to the s911D Condition.

2.8 ***B5Q1: Do you agree with the proposed transitional period? If not, do you think it should be longer or shorter?***

Given the time practically needed by FFSPs and Australian institutions and superannuation funds to:

(a) review and update their arrangements for the CP 315 reforms;

(b) become fully aware of and trained in relation to their rights and obligations under the reforms; and

(c) put in place adequate and robust control mechanisms to ensure compliance under the new arrangements,

we request that the proposed transitional period is at least 24 months for both the foreign AFS licence (**Foreign AFSL**) regime and for the funds management relief.

2.9 ***D1Q1: Do you think we have provided adequate guidance to FFSPs about how our proposed regulatory framework for FFSPs will apply? If not, why not? Please be specific in your response.***

We would appreciate ASIC's guidance on the following questions which arose from reading the draft RG 176:

(a) How many months before 31 March 2022 does a Foreign AFSL application need to be submitted in order to qualify for an extension to the transitional relief (and for the delay in processing the application to not be regarded as due to the applicant's delay, noting that draft RG 176.115 provides "*An extension of the transitional relief will only occur in rare and exceptional circumstances, and will not be granted if it is solely due to delays with lodgement by an applicant*"). Guidance on this timing point would alleviate the uncertainty faced by potential Foreign AFSL applicants at the moment.

(b) Will ASIC's service charter be updated to cover ASIC's targets for processing Foreign AFSL applications? We note that ASIC's service charter currently provides that ASIC aims to decide whether to grant a full AFSL within 150 days of receiving a complete application and aims to decide 90% of complete applications within 240 days.

(c) Would ASIC be open to permitting a wholly owned Australian subsidiary (under section 46 of the Corporations Act) of a FFSP whose overseas licence or permission is in ASIC's view sufficiently equivalent to an AFSL, to apply for a Foreign AFSL?

    (1) Local subsidiaries are often used in a large corporate group to segregate its business activities in the different jurisdictions for good governance, compliance, accounting, tax, conflicts and risk management purposes.

    (2) If a deed of undertaking/enforceability was provided to ASIC in connection with the Foreign AFSL application by both the FFSP and

by the wholly owned Australian subsidiary and the FFSP were to undertake in the deed to guarantee the performance by its subsidiary of its obligations under the Foreign AFSL, would that address ASIC's regulatory concerns in relation to a wholly owned subsidiary applying for a Foreign AFSL?

(3) There would be clear benefits to Australian based clients of dealing with an Australian counterparty based in Australia compared to dealing with a foreign company which has appointed a local agent for service.

(4) The benefits to the FFSP include:

(A) greater efficiency in relation to the management of its tax and financial reporting and general compliance obligations in relation to the Australian business; and

(B) not needing to incur the costs and obligations of registering as a foreign company.

(5) We understand that many FFSPs, particularly US based FFSPs, are not required to make their financial reports publically available in their home jurisdiction or are able to lodge accounts on a 'commercial in confidence basis', where they are not available to the public. We also understand that the ability to safeguard this commercially sensitive accounting information is commercially very important to them, so much so that they may be deterred from applying for a Foreign AFSL and continuing to provide services to Australian clients if they will be required to lodge their accounts with ASIC.

(6) The advantage of allowing a wholly owned Australian subsidiary to hold the Foreign AFSL is that the foreign controlled Australian company would need to lodge its own accounts with ASIC, which would be publically available, but the FFSP parent would not be required to publish its foreign accounts in Australia.

3 Additional information

If you have any questions in relation to this submission or would like to receive any additional information or explanation, please let us know.

Yours sincerely

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