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Australian Securities and Investments Commission
Product Regulation
Strategic Policy
GPO Box 9827
Brisbane QLD 4001

By email
product.regulation@asic.gov.au

Dear Sir/Madam

ASIC CP 325 - Product Design and Distribution Obligations ("DDO")

1. We are concerned that the DDO obligations may inadvertently apply to exchange traded funds quoted on ASX (under Schedule 10A of the ASX Operating Rules – also known as the AQUA Rules) and Chi-X (**Quoted Funds**) because of technical issues in respect of the operation of such funds. Such funds are traded under a different set of rules and pursuant to different operational structures as compared to listed investment trusts and listed investment companies. In particular, we are concerned that:
 - (a) Quoted Funds may technically be engaging in "retail product distribution conduct" on an ongoing basis, despite trading in such funds generally being thought of as secondary trading, because:
 - (i) Quoted Funds are open ended funds, meaning interests in such funds are issued and redeemed daily in the normal course of trading (as opposed to listed investment trusts and listed investment companies, which are closed ended, meaning transactions in closed ended vehicles are generally all secondary trading of historically issued interests i.e. issuance rarely occurs in respect of close ended vehicles). Quoted Funds are therefore required to redeem or issue new units daily, based on the daily net trading volume of the fund on ASX or Chi-X;
 - (ii) Quoted Funds use market making (which can be either internal market making (**IMM**) or external market making (**EMM**)). In respect of IMM, the fund's market maker is appointed on an agency basis (i.e. all market making transactions occur with the fund being one of the counterparties to each trade). In respect of EMM, the fund's market maker is appointed on a principal basis (i.e. all market making transactions occur with the market maker being one of the counterparties to each trade). In each case the secondary trading normally occurs shortly after the securities are issued. Therefore we are concerned that these trades could be

considered to amount to "*dealing in the product in relation to a retail client*" for the purposes of the definition of "*retail product distribution conduct*" in the new section 994A(1). We assume this is not the intended outcome as "*disposing of a financial product*" is specifically carved out of the definition of "*dealing*" for the purposes of Part 7.8A. However, it would be good to receive clarity on this point;

- (b) for the same reasons as described above, Quoted Funds using market making may technically be subject to the obligation imposed by s994B(8) (which we assume is not intended to capture secondary trading) to ensure that for products issued or sold in a regulated sale:
 - (i) to a retail client in accordance with the distribution conditions—it would be likely that the retail client is in the target market; and
 - (ii) to a retail client in the target market—it would likely be consistent with the likely objectives, financial situation and needs of the retail client; and
 - (c) Quoted Funds could also then be required to prepare a target market determination (**TMD**) under regulation 7.8A.09 on an ongoing basis given the ongoing issue of fund units (pursuant to the open ended nature of such funds) as described above. It is unclear whether this is Treasury's intention (for the reasons set out below under "Conflict with Revised Explanatory Memorandum").
2. If the trustee of a Quoted Fund were considered to be engaging in "retail product distribution conduct", or otherwise taken to be issuing to retail clients in the overall context of the proximity of issuance to market makers to subsequent secondary trading by the market makers (or engaging in regulated sales), the fund would need to (among other things):
- (a) comply with s994E(3) to ensure that the trustee takes reasonable steps that would have resulted in, or would have been reasonably likely to have resulted in, the retail product distribution conduct being consistent with the TMD for the Quoted Fund; and
 - (b) comply with s994B(8) as described above.
3. In our opinion, there are no reasonable steps for the trustee of a Quoted Fund to take to ensure that distribution of Quoted Funds via the ASX or Chi-X secondary market will, in respect of retail clients:
- (a) be, or will likely be, consistent with the product's TMD;
 - (b) to a retail client in accordance with the distribution conditions—it would be likely that the retail client is in the target market; or
 - (c) to a retail client in the target market—it would likely be consistent with the likely objectives, financial situation and needs of the retail client,

given the open nature of trading on the ASX and Chi-X.

4. For the avoidance of doubt, we note that DDO obligations should apply to Quoted Funds where the Quoted Funds engages in any targeted issuance (for example, some Quoted Funds will engage in IPO style launches upon the initial quotation of the fund).

Conflict with Revised Explanatory Memorandum

5. In the Revised Explanatory Memorandum (**EM**), Treasury states that the DDO obligations cease to apply if the product is no longer available to consumers by way of primary or initial offering and section RG 000.17 of the draft Regulatory Guide in respect of DDO states that "Issuers and distributors do not have to comply with the design and distribution obligations for secondary sales of products, unless such sales are made in circumstances that could otherwise be used to avoid the obligations (regulated sale)".
6. As set out above, there are a number of technical issues that may result in Quoted Funds being subject to DDO obligations on an ongoing basis beyond the primary or initial offering. As Treasury's stated intention is that secondary trading should generally not be subject to such obligations, we recommend that more detailed and explicit guidance be issued in respect of the above mentioned issues.
7. We recommend that further guidance is issued by Treasury and ASIC to clarify that :
 - (a) Quoted Funds are not required to prepare and maintain a TMD on an ongoing basis (or only upon initial quotation or other targeted fund raising activity);
 - (b) daily issue of Quoted Fund units does not constitute "retail product distribution conduct";
 - (c) daily issue of Quoted Fund units by to market makers with subsequent sales to retail investors does not constitute issuance to retail clients generally (and also confirmation whether such issuance would generally be or not be a regulated sale);
 - (d) provide more guidance on Quoted Funds generally and what obligations they have under DDO, including by way of examples in the Regulatory Guide in respect of DDO. We note that the draft Regulatory Guide makes no mention of Quoted Funds and, in terms of classes of exchange traded products, only refers to Listed Investment Trusts (LIT) and Listed Investment Companies (LIC) (for example, Example 11 in respect of LICs and the accompanying Note 2 which states the example is also applicable to LITs);
 - (e) if our analysis does not apply, what actions should issuers of Quoted Funds take to ensure compliance with DDO, noting that:

- (i) issuers may not place conditions or restrictions on trading on the ASX or Chi-X;
- (ii) issuers are not otherwise able to affect who trades in Quoted Funds on the ASX or Chi-X;
- (iii) market makers are not intended to take an active role with respect to distribution and merely facilitate trading at fair prices by market participants.

Yours sincerely



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