TREASURY CONSULTATION ON STAMPING FEE EXEMPTION
RESPONSE OF THE AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

20 FEBRUARY 2020

INTRODUCTION

1) Listed investment entities (i.e. Listed Investment Companies (LICs), Listed Investment Trusts (LITs) and Real Estate Investment Trusts (REITs)) have played an important role in bringing diversity and choice to investors in the Australian market. This submission does not question the merits of these products. It responds directly to Treasury's consultation on the merits of the current stamping fee exemption in relation to listed investment entities.

2) Most of this submission is directed at LICs and LITs. While the distribution of REITs generates some of the same conflicts of interest as LICs and LITs, their growth has been limited over recent years. Unlike LICs and LITs whose primary purpose is investment in shares and other financial products, REITs play an important role in the real economy by directly buying and managing real assets (real-estate).

Key observations

3) Stamping fees may **distort the allocation of capital between products**. Stamping fees create an incentive for stockbrokers and other financial advisers to put clients into LICs and LITs over other comparable products that do not pay stamping fees (e.g. exchange traded products (ETPs) and unlisted managed investments schemes).

4) Investors of LIC and LIT capital raisings are **overwhelmingly retail**. The distribution of the products typically occurs under **personal or general advice** models.

5) The Final Report of the Financial Services Royal Commission observed generally that *self-interest will almost always trump duty*. With that observation in mind, we submit that **conflicts of interest arising from stamping fees are too great to be effectively managed** and should be avoided, since:
   a) the closed-ended nature of the products creates a strong incentive for issuers to maximise capital raised at the initial and subsequent offers, leading to the payment of stamping fees and other incentives;
   b) stamping fees are ad valorem and create a strong incentive for stockbrokers and other financial advisers to maximise the client money they bring to a capital raising. They typically keep stamping fees themselves, although a minority of advisers do not take the fee or pass it on to clients; and
   c) many clients come through stockbrokers and other adviser groups that have a broader role in the capital raise (e.g. arranging or managing the deal). These firms' broader interest in a successful capital raising compounds the conflict by incentivising advisers to sell these products to retail clients.

6) There is compelling evidence that **clients in initial capital offerings of LICs and LITs experience poorer outcomes** relative to other opportunities:
   a) they buy in at a price that reflects the net tangible asset (NTA) value of the product, but the majority of LICs and LITs go on to trade at a discount to NTA on the secondary market. This can lead to a relative or absolute loss when investors eventually sell the product; and

b) they tend to underperform (in some cases materially) against relevant benchmarks and other comparable products. The opportunity cost of investing in many LICs and LITs is foregone profits (or the minimisation of losses).

7) While we appreciate the timing of any change to the conflicted remuneration regime is a matter for Government, **ASIC submits that the most effective way to deal with the conflicts of interest is to remove the exemption for stamping fees for LICs and LITs** whose primary purpose is investment in shares and other financial products.

8) If the stamping fee exemption for LICs and LITs were **repealed**, we expect potential **adverse consequences to be limited**, including a decline in the issuance of new LICs and LITs, and would be outweighed by the benefits to consumers. There is evidence and examples in Australia and abroad that LICs and LITs can **successfully raise capital without stamping fees**. Stockbrokers and other financial advisers have a range of revenue streams, so we do not believe this will materially undermine their business models.

9) **ASIC supports a broader review of exemptions from the ban on conflicted remuneration**, including for REITs, which we understand is scheduled for 2022. If the Government removes the exemption for LICs and LITs before this broader review, we do not expect this will materially distort the broader market for listed products. This is because other listed products that have an exemption from the ban on stamping fees tend not to directly compete with LICs and LITs.

10) Regardless of whether the exemption is retained, the existing rules for advising and distributing financial products will continue to apply to LICs and LITs. Where personal advice is provided about LICs and LITs, it must comply with the best interest duty and we expect that LICs and LITs will be distributed in compliance with the financial services laws that apply.

Structure of this submission

11) In this submission, we:
   a) provide some background on LICs and LITs and the conflicted remuneration regime;
   b) outline how the conflicts of interest that are created by stamping fees and the relatively poor performance of LICs and LITs can result in poor outcomes for consumer that buy these products at the initial capital raising stage;
   c) outline how stamping fees undermine competitive neutrality among similar products;
   d) reflect on possible consequences of removing the stamping fee exemption;
   e) provide some background on LICs and LITs (**Attachment A**) and origination and distribution practices (**Attachment B)**; and
   f) address the commentary on ASIC's initial analysis on LICs and LITs that was released under a Freedom of Information request (**Attachment C**).

12) Our observations have been informed by ASIC's supervisory oversight of this market. This includes analysis of stamping fees and performance of LICs and LITs, surveillance activities and on-site reviews of advice provided by stockbrokers, and engagement with fund managers, industry bodies, stockbrokers, banks, exchanges and overseas regulators.

ABOUT LICS, LITS AND REITS

13) LICs and LITs have been available in Australia for close to a century. They are incorporated companies or trusts listed on an exchange that invest in underlying assets (e.g. a basket of equity and/or debt securities). REITs are a separate class of LIT which directly own and manage properties or real estate debt (e.g. office buildings, warehouses and shopping malls).

14) LICs, LITs and REITs are closed-ended, meaning the number of shares or units on issue is fixed upon initial offer and listing. Investors can only sell their shares/units on the secondary market (i.e. they cannot redeem the investment directly with the manager of these products), nor are there market making and redemption mechanisms to assist market efficiency. As a result, these products can and do trade at prices that deviate from the underlying NTA held.

15) This compares to the more recently developed ETPs, which have been available in Australia since the early 2000s, are open-ended and do not benefit from stamping fees. They usually trade around NTA (the ability to create or redeem units provides arbitrage opportunities if prices diverge from the underlying NTA). They also tend to have market makers, which ensures there are bids and offers in the market through the trading day and can help to promote liquidity and tighter spreads (i.e. the difference between the bid and offer price).

16) The closed-ended (i.e. fixed capital) structure of LICs and LITs, and the fact that managers are usually remunerated by reference to net asset value, is a strong motivation for issuers to raise as much capital as possible prior to listing. This has been done (inter alia) by paying stockbrokers and other licensees stamping fees and other fees to access their distribution networks and solicit client investment. The stamping fees paid are proportional to the value of successful applications procured.

CONFLICTED REMUNERATION REGIME AND THE STAMPING FEE EXEMPTION

17) The Future of Financial Advice reforms amended the *Corporations Act 2001* (Corporations Act) to introduce a ban on conflicted remuneration. Conflicted remuneration is any benefit given to an AFS licensee, or its representative, that provides financial product advice to retail clients that could reasonably be expected to influence either the choice of financial product recommended, or the financial product advice given to clients by the licensee (s963A). Benefits that are wholly or partly dependent on the value of financial products acquired by retail clients to which a licensee or its representative provides financial product advice are presumed to be conflicted remuneration (s963L).

18) The conflicted remuneration provisions apply to both personal and general financial product advice given to retail clients, regardless of the channel used to communicate the advice (e.g. advice that is provided verbally, in paper-based format, by email or online).

19) The original regime, which commenced on 1 July 2013, had an exemption for ‘stamping fees’ paid in relation to certain capital raising activities by entities that ‘made things and provided services’ (Reg 7.7A.12B). The rationale was that absent conflicted payments, securities issued through initial public offerings (IPOs) could not be sold and this may have an adverse impact on the real economy by restricting companies’ access to capital.

20) The original exemption did not apply to 'investment entities' (such as LICs, LITs and REITs) whose primary purpose was to invest in other financial products or investments, unless that investment was an 'infrastructure entity' that provided a return from investing in airports, electricity or gas production and distribution facilities, hospitals, and other essential infrastructure.

21) The exemption from the conflicted remuneration regime was expanded to investment entities such as LICs, LITs and REITs with effect from 16 December 2014.

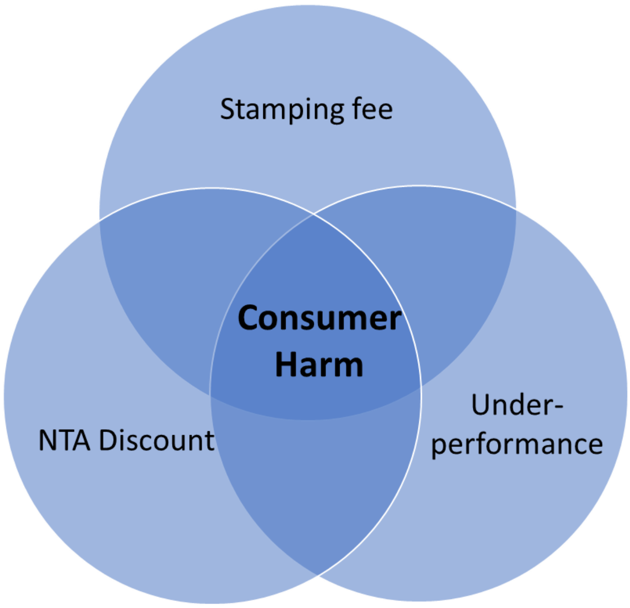
22) The Corporations Regulations define 'stamping fees' to mean a fee, or part fee, given to facilitate an approved capital raising if it is a fee paid 'in connection with' an offer by the issuer to issue or an invitation by the issuer for an application to issue the financial product. This includes traditional 'stamping fees' for selling the product, often referred to in disclosure documents as selling fees or broker firm fees. It may also include other fees that could reasonably be expected to influence advice given to retail clients.

CONFLICTS OF INTEREST FROM STAMPING FEES IN THE SALE OF LICS AND LITS

23) The conflicted and other banned remuneration provisions primarily aim to more closely align the interests of those who provide advice with the interests of their retail clients and improve the quality of advice these clients receive. Conflicted remuneration can lead to consumer harms entrenched across a wide range of retail financial services.

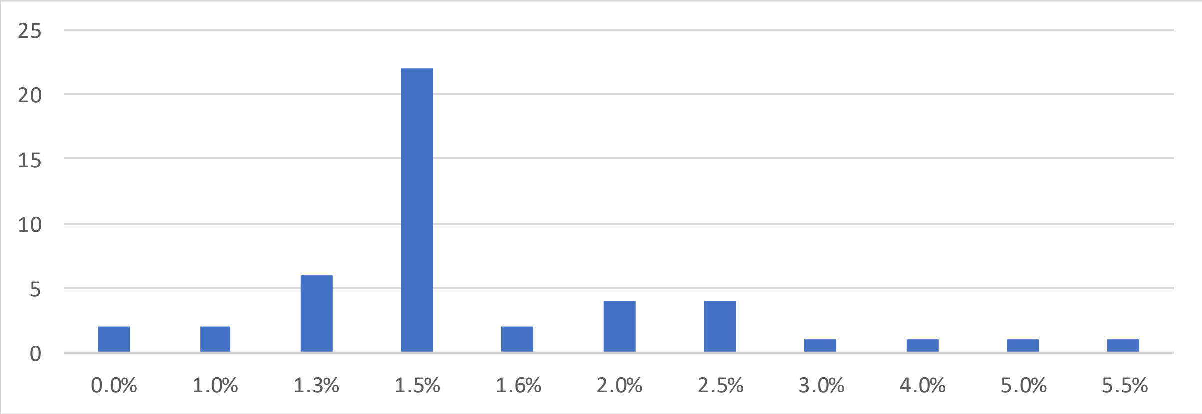
24) The stamping fee exemption creates an inherent conflict of interest between stockbrokers and financial advisers and their retail clients. Each adviser has a strong financial incentive to recommend investment in these products at IPO stage as a result of the stamping fee. **Figure 1** illustrates how the conflicts of interest caused by stamping fees combined with the NTA discount and underperformance (which are discussed in subsequent sections) can lead to consumer harm.

Figure 1: Impact of Stamping Fee Exemption on Consumers



25) Over the 5 years to the end of 2019, close to half of new LIC and LIT issuances (excluding conversions) paid 1.5% in stamping fees, with around 22% paying less and 30% paying more (see **Figure 2**). Some issuances have paid up to 5.5% in up-front stamping fees in order to complete the LIC/LIT offer.

Figure 2: Distribution of LIC and LIT Selling Fees Between 2015 and 2019



26) We estimate that over the 5 years to end 2019, stockbrokers and other financial advisers have earned over $186 million in ‘stamping fees’, or what public offer documents refer to as broker or adviser fees, from more than $14 billion of initial capital that has been raised by LICs and LITs. This amount does not include secondary capital raised in the form of secondary equity offers, entitlement rights and attached company options.

27) Further, stockbroking and other financial advisers have a strong incentive to encourage associated advisers to have their clients invest in these products at IPO stage. This is as a result of the significant Joint Lead Manager (JLM) or arranging ‘success’ fees they are often paid if the IPO is successful (see **Attachment B**). This could run into the millions of dollars for a single stockbroking or financial advice firm. We estimate that over the 5 years to end 2019, the combination of stamping fees and JLM and arranger fees, firms involved in the raisings could have earned well in excess of $330 million. As a result, the interests of the stockbroking or other financial advisory firm and the individual adviser are aligned in a way that can result in retail consumers being placed into investments that are not optimal for their circumstances or that deliver worse outcomes than other comparable opportunities.

28) Several major banks have advised that they have declined involvement in LIC and LIT IPOs following due diligence of the offer structure and terms, only to see the same product promoted by other stockbrokers and financial adviser groups in the market. We expect the stamping fees may have influenced the decision of the other entities to support these products.

29) As part of our supervisory activities, if we identify conduct that indicates an adviser has breached their best interest duties in providing personal advice to retail clients, we would take appropriate action. It can, however, be difficult to establish to the levels required by law that an adviser has not acted in the best interest of clients where they are providing advice across a range of widely available products and services, they have robust policies and procedures for managing conflicts of interest, and they have followed those policies and procedures.

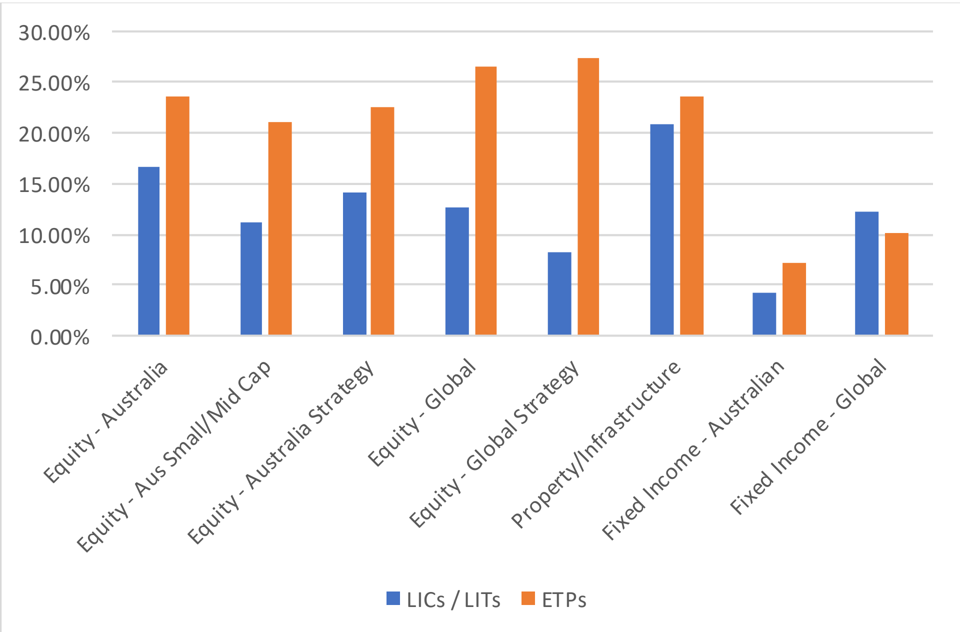
30) Many allocations to retail clients occur under general advice rather than personal advice models,[1] where the best interest duty does not currently apply. Therefore, the best interest duty itself, is not adequate to deal with the conflicts of interests and potential risk of consumer harm that stamping fees create.

UNDERPERFORMANCE AND DISCOUNT TO NTA OF LICs AND LITs

31) We submit that the conflicts of interest outlined above have resulted in a material number of retail consumers putting their funds into LICs and LITs at the IPO stage, and for many of these customers, the investment will have significantly underperformed comparable products.

32) In the 5 years to end 2019, 45 out of the 51 newly listed LICs and LITs (and are still listed) were issued with stamping fees.[2] As at end of 2019, the 51 LICs and LITs had an average one-year return of 13.42% (median 13.95%) and traded at an average discount to NTA of 7.27% (median 7.73%). As at end of 2019, the 46 non-conversion LICs and LITs had an average one-year return of 13.01% (median 13.12%) and traded at an average discount to NTA of 7.25% (median 7.00%). **Figure 3** shows the last year average performance of LICs and LITs compared with ETPs across a range of asset classes. The vast majority of capital in LICs and LITs is in equities (90% of their market capitalisation). ETPs are substantially more diverse (see **Attachment A**: paragraph 62).

Figure 3: 1-Year Returns on LICs and LITs vs ETPs Across Different Categories for 2019



33) **Table 1** provides a comparison of 1, 3 and 5-year average returns of all LICs and LITs against ETPs and mFunds (OTC funds that can be settled through ASX) across different underlying asset class categories as at year end 2019 (excluding geared and negatively correlated funds). This broad

[1] Personal advice is defined in s766B of the Corporations Act as financial product advice that is given to a person where the provider of the advice has considered one or more of the person's objectives, financial situation and needs, or a reasonable person might expect the provider to have considered one or more of those matters. General advice is financial product advice that is not personal advice.
[2] Five that did not pay stamping fees were results of corporate restructures and/or did not raise capital.

comparison indicates that LICs and LITs tend to materially underperform ETPs and mFunds across the periods and across comparable asset class categories.

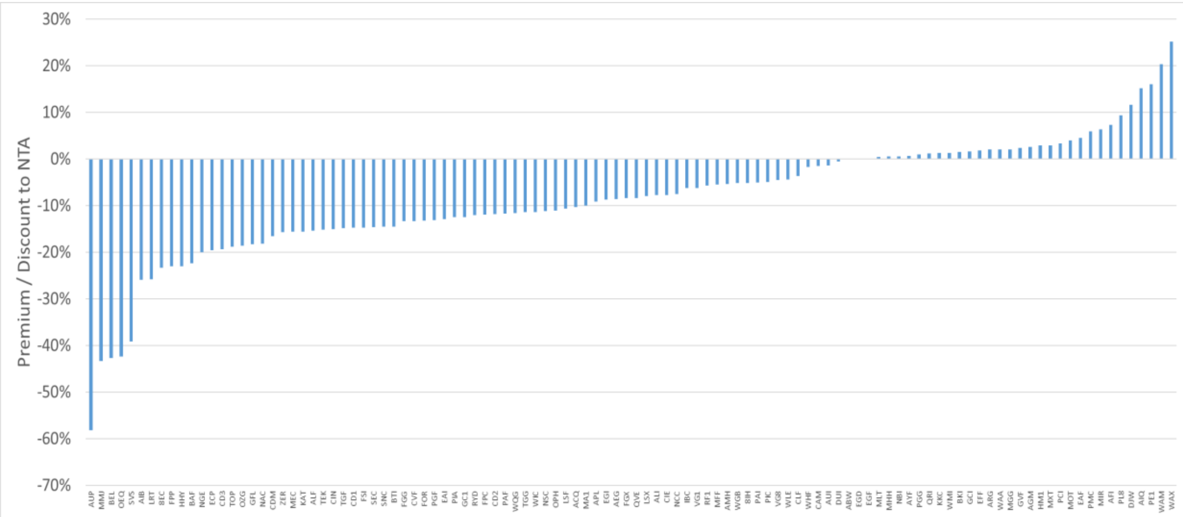
Table 1: Summary Performance of LICs and LITs vs ETPs and mFunds

Average Excl. Geared and Negatively Correlated	1 Year Return			3 Year Return			5 Year Return		
	LICs / LITs	ETPs	mFunds	LICs / LITs	ETPs	mFunds	LICs / LITs	ETPs	mFunds
Equity - Australia	16.68%	23.51%	25.88%	8.91%	11.12%	11.03%	7.35%	8.58%	10.48%
Equity - Australia Small/Mid Cap	11.18%	21.08%	35.37%	2.78%	9.73%	12.71%	5.62%	8.02%	13.94%
Equity - Australia Strategy	14.19%	22.49%		-2.38%	8.72%		0.43%	6.96%	
Equity - Global	12.62%	26.59%	25.09%	2.67%	12.27%	13.33%	4.60%	11.89%	11.13%
Equity - Global Strategy	8.23%	27.27%		1.98%	13.03%		-6.35%	9.99%	
Fixed Income - Australian	4.31%	7.16%	5.34%		4.92%	3.92%		4.44%	3.35%
Fixed Income - Global*	12.29%	10.04%	6.82%		5.07%	4.28%			4.02%
Property/Infrastructure*	20.87%	23.66%	23.48%	15.54%	10.90%	10.26%		12.10%	8.55%
* Only one LIC observation in Fixed Income - Global and only two LIC observation in Property/Infrastructure									

Note: This table is based on averages. We repeated the analysis with market capitalisation weighted performance as well as an all-inclusive universe of products, which yielded broadly similar results.

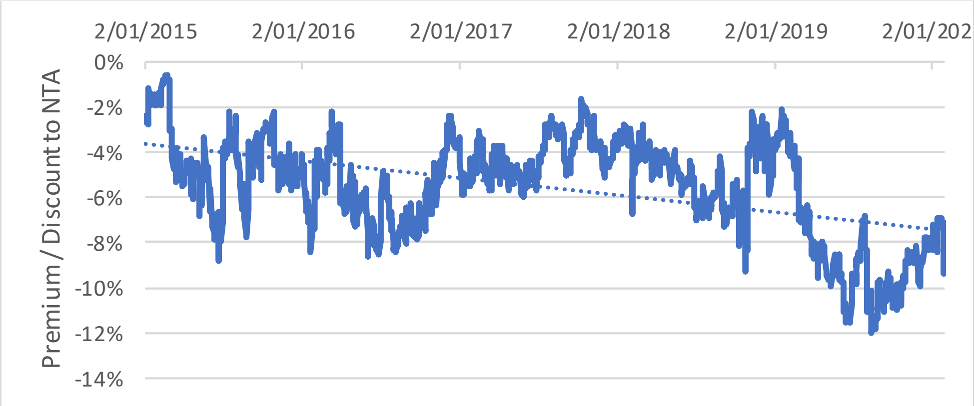
34) The majority of LICs and LITs trade at a discount to NTA. **Figure 4** shows the range of premiums and discount to NTA of all LICs and LITs as at the end of 2019. The number and proportion of LICs and LITs trading at discounts to NTA have increased significantly since 2015.

Figure 4: Premiums / Discounts to NTA for LICs and LITs – 31 December 2019



35) The magnitude of discount to NTA across LICs and LITs has increased gradually over time (see **Figure 5**). The current average discount to NTA for all currently listed LICs and LITs is close to 10%. This is significantly greater than the average in the US calculated by the Closed-End Fund Association of close to 3%, and in the UK where the Association of Investment Companies has published an average 1.4% discount to NTA as at end 2019. This represents a real and tangible cost to consumers who seek to sell their investment in LICs and LITs (if they held the underlying basket of assets themselves, they could sell them at the NTA values).

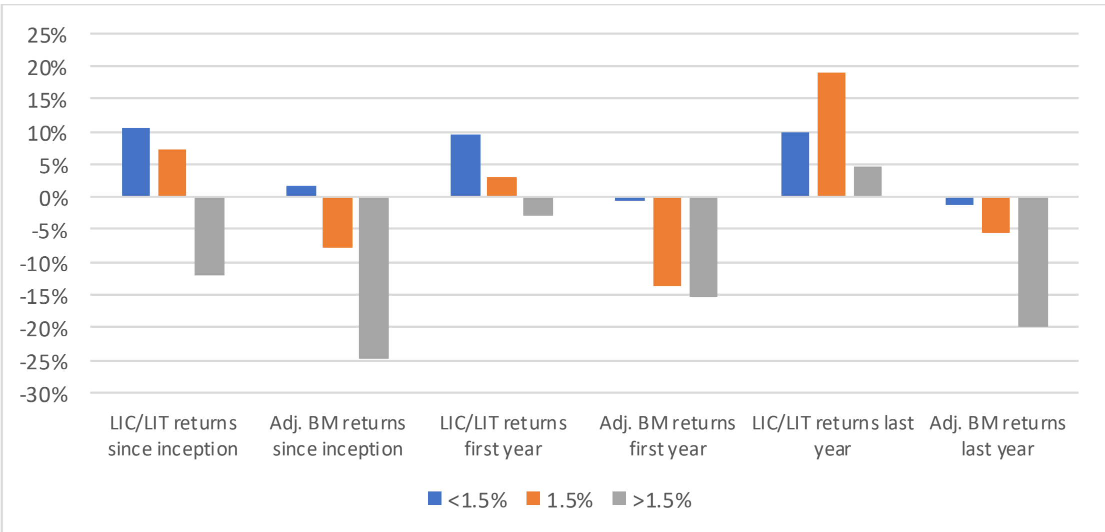
Figure 5: Discount to NTA for LICs and LITs



36) We found that LICs and LITs that paid higher stamping fees tended to underperform on the secondary market compared to those that paid lower or no stamping fees (see **Figure 6**) and had greater discounts to NTA (see **Figure 7**). We also understand anecdotally that higher stamping fees have been needed for some LICs and LITs to be successfully listed. This can distort the market for distribution of these products since brokers and advisers may be incentivised to sell products with higher fee potential for them than the same product with lower fees.

37) **Figure 6** shows the returns for the 46 current non-conversion LICs and LITs listed between 2015 and 2019 as at end of 2019, grouped by stamping fees. LICs and LITs paying below the standard 1.5% consistently perform better than those paying 1.5%, which in turn perform better than those paying above 1.5%. Returns are presented both in absolute terms, as well as adjusted for benchmarks (Adj. BM returns) in the same asset classes. This pattern is generally persistent for returns since inception, in the first year following listing, and in the year ended 2019.

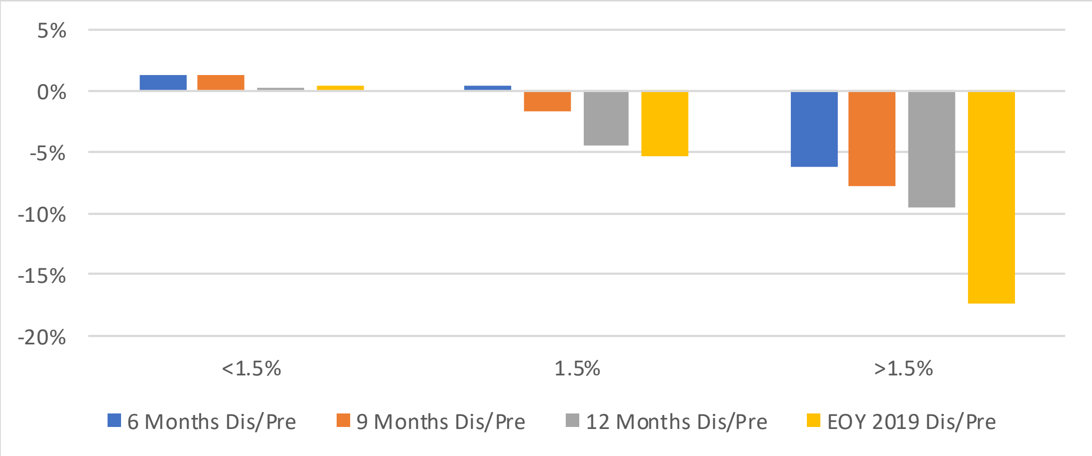
Figure 6: LIC and LIC Returns on Secondary Market Grouped by Stamping Fees (Excluding Conversions)



38) **Figure 7** shows average premium or discount to NTA post listing of LICs and LITs grouped by stamping fees as at end 2019 for the 46 current non-conversion LICs and LITs listed between 2015 and 2019. For all groups, discount to NTA tends to increase over time following IPO. LICs

and LITs paying below the standard 1.5% consistently fare better than LICs and LITs paying 1.5%, and above. This could indicate that poorer quality LICs and LITs are relying on higher stamping fees for them to successfully list, and suggest that objective due diligence by brokers may be impacted by higher stamping fees.

Figure 7: Conflicted Selling Incentives and Discount / Premium to NTA (Excluding Conversions)



39) It is worth noting that there are individual LICs and LITs that have performed well compared with their asset class benchmark and many have established strong track records for decades with long investment horizons and relatively low management fees.

HOW DOES DISCOUNT TO NTA AND UNDERPERFORMANCE IMPACT CONSUMERS?

40) The discount to NTA is an important measure as it represents a real, and calculable, loss to consumers who seek to exit their LIC or LIT investment, particularly when they have acquired the financial asset at IPO stage. While LICs and LITs are sold as liquid products that can be sold on market, investors may not be aware of the money they likely forego by doing so. This compared to other products like ETPs and unlisted investment schemes which, because of their design, can be bought and sold for close to NTA.

41) The relative underperformance of these products for investors that buy in at IPO can create significant opportunity costs for consumers (e.g. through foregone profits or loss minimisation) had they invested in an equivalent ETP.

Example 1 - Impact on consumers of discounting to NTA and underperformance

To show the impact of this discounting to NTA and underperformance, take the example of a consumer who made an investment in a LIC IPO in mid-2015 through an adviser. The LIC had an investment strategy of investing in small and medium-sized Australian listed companies and it significantly underperformed (by around 60%) the relevant index as well as a comparable ETP.

The consumer invested $100,000, for which the adviser received $2,000 (2%) in stamping fees. Three years later, the investor sold the shares in the LIC for their market value of $110,000, which was at a 15.6% discount to NTA. They also received $11,750 in dividends over the three years. Before brokerage fees and taxes, the total profit on this investment was $21,750.

Had this consumer invested the same amount in an ETP with a similar underlying benchmark exposure, they would have sold the ETP shares for $147,200. Adding in $9,850 in distributions, the total profit on this investment was $57,050 (i.e. over twice the return) before brokerage fees and taxes. Even with the potential tax benefits from a larger percentage of franking credits in the LIC, the LIC investment still significantly underperformed the ETP.

Note: This example is based on the performance and fee levels of a real (and broadly equivalent) LIC and ETP over the period and is indicative of how many LICs have performed.

42) While there are individual LICs and LITs that have performed well compared with their asset class benchmark, our concern is that stamping fees create conflicts of interest for brokers and advisers when selling LICs and LITs on the primary market at full NTA. It is clear from the data that these products typically trade at a discount to NTA soon after issuance, which worsens over time, and relatively underperform other similar products on the secondary market.

Impact of Taxation

43) We do not consider the difference in percentages of franking credits of LICs compared to other investment structures is significant enough to compensate for the relative underperformance and discount to NTA. This is supported by our further internal analysis along with third party analysis on this issue. The impact of franking credits, and the tax treatment of different investment products are inevitably highly dependent on the structure of the investment and the circumstances of the investor.

44) While some LICs and LITs pay dividends with 100% franking credits, the average franking credits are somewhat lower, particularly for foreign equity or fixed income LICs and LITs where the underlying investments do not pay franking credits. ETPs that invest in Australian equities also pass through franking at around 60-90% depending on the franking credits received from investee companies.

45) The difference in franking credits is only relevant for dividends paid or gains or losses realised over the year. Unrealised capital gains do not incur a tax expense. This may mean a typical dividend payout of 5% of NTA may be 1-2% higher as a result of franking credits. ETPs will also have a slightly higher return due to franking credits. Given Table 1 reflected LIC and LIT underperformance of generally 5% or more over the past year, the benefit of the franking credits does not nearly equate to compensating for the underperformance of the underlying product.

46) Importantly, all of the perceived benefits of LICs and LITs are also available to investors when these products are purchased on the secondary market without the influence of stamping fees.

COMPETITIVE NEUTRALITY IMPACTS OF THE STAMPING FEE EXEMPTION

47) While stamping fees can create a competitive advantage for all product types that are able to benefit from them, including LICs, LITs, REITs and securities in new company listings, we consider that the greatest competition impacts occur between products with similar underlying assets.

48) The current stamping fee exemption creates an unlevel playing field between LICs and LITs, on the one hand, and ETPs and other managed investment products that are in direct competition and do not benefit from stamping fees.

49) In a competitively neutral market, a large number of these LICs and LITs trading at a substantial discount to NTA would represent an opportunity for investment. Incoming investment could increase the prices and thereby reduce the discount to NTA. However, with the incentives available to stockbrokers and financial advisers to sell new issuances of LICs and LITs, we expect that this investment is instead funnelled into new issuances and secondary raisings which has resulted in increasing discounts to NTA. The competitive distortions created by stamping fees causes a real loss both to consumers who invest in new LIC and LIT IPOs, but also those already invested in these products that are trading at higher discounts to NTA. We expect stamping fees have also led issuers to select LIC and LIT structures over other product structures that do not pay stamping fees given that advisers are strongly incentivised to promote these products based on the remuneration they receive rather than on the merits of the investment offering.

50) We surmise that the significantly higher discount to NTA of the average LIC in Australia compared to overseas markets the consequence of this competitive disparity. In the absence of the conflicts of interest caused by stamping fees, we believe the average discount to NTA should move closer to that in other countries. This would reduce the loss to those who invest at IPO or secondary raising stage then, for any reason, decide to liquidate these products.

51) If the Government is minded to remove the conflicted remuneration exemption for stamping fees for LICs and LITs sooner than other products that currently benefit from the exemption (e.g. listed companies that provide goods and services, or own real estate assets such as REITs), we do not expect this will materially distort the market because these other products do not directly compete with LICs and LITs.

WHAT WOULD HAPPEN IF THE EXEMPTION WAS REMOVED FOR LICS AND LITS?

52) We have considered the impact of any changes to the stamping fee exemption on issuers of LICs and LITs, financial services licensees and their representatives who distribute these financial products and, retail consumers of these financial products.

Impact on consumers

53) We believe consumers would benefit from the removal of the exemption by receiving better quality advice (with fewer conflicts) on investment options. This could include advice to invest in LICs and LITs on the secondary market, or in other products that trade closer to NTA such as ETPs and unlisted managed investment schemes. As we observe above, in recent years ETPs have generally outperformed LICs and LITs, and so the removal of the stamping fee exemption may result in more investors selecting ETPs.

54) The quality of LICs and LITs available to investors is also likely to improve. We think that the availability of stamping fees has concentrated the types of products willing to be supported by firms with distribution networks, limiting innovation and diversification in asset allocation in these products.

55) We recognise that if stamping fees on LICs and LITs are banned but retained for other listings, there is a risk of retail clients being put into other products that offer these incentives. We will monitor this closely and input into the Government's planned broader review of exemptions to the conflicted remuneration regime.

Impact on issuers and distributors

56) The removal of the exemption would create a more level playing field between these and other investment products that do not benefit from the exemption (e.g. ETPs and unlisted managed investment schemes). Removing the exemption may, therefore, result in fewer new LICs and LITs being issued in favour of other product structures.

57) However, as evidenced by the continued strong demand for closed-end funds in the UK despite commissions being banned on LICs and other financial products, we would not expect the removal of the stamping fee exemption for LICs and LITs to prevent the continued issuance of these products. Where LICs and LITs offer a compelling investment strategy, high-quality management, and reasonable fee levels, advisers could recommend, and consumers may decide to invest in, these products. In fact, there have been a number of LICs launched recently in Australia that have not paid stamping fees and, in the short period of time that LICs and LITs did not benefit from the stamping fee exemption in 2014, we did not see a downturn in the number of LIC and LIT IPOs.

58) Some in the industry have commented to us that there may be more, rather than less, innovation in these products by removing the need to pay distribution fees in order to launch their products. This is because currently those in distribution networks are unwilling to promote novel products without the payment of stamping or other distribution fees.

Impact on advisers and brokers

59) There may be some impact on those stockbrokers and financial advisers that currently receive stamping fees and would no longer receive this revenue. As a result, those entities may need to consider alternative revenue streams or charge investors for advice.

60) As outlined in **Attachment B**, many of these firms are also involved in (and remunerated from) the arranging and management of new issues and may continue to receive this revenue where it is not conflicted remuneration under the Corporations Act.

ATTACHMENT A: THE MARKET FOR LICS AND LITS

61) There are currently 113 LICs and LITs listed in Australia with a total market capitalisation of around $53 billion as at end of 2019 (see **Figure 8**). Over the 5 years to the end of 2019, the number of LICs and LITs increased by more than 70% and we estimate that over $14 billion of initial capital was raised by new LICs and LITs (this excludes secondary capital raisings). The number of REITs remained stable over the same period, while overall market capitalisation increased to $148 billion as at end of 2019.

Figure 8: LIC and LIT Market Growth

Source: ASX Investment Products Report December 2019

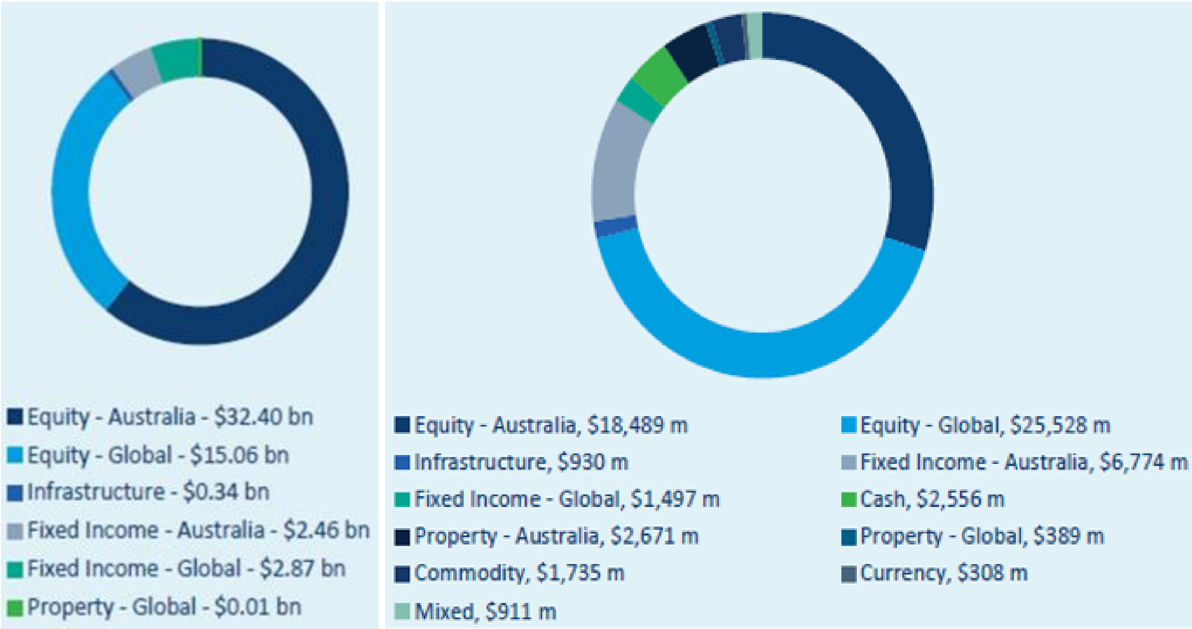
62) There has also been considerable growth in ETPs, doubling over the 5 years to 211 and a market capitalisation of $62 billion as at end of 2019. Separately, the number of unlisted managed investment schemes registered with ASIC remained roughly unchanged at around 3,700. This suggests that there is growing demand for diversified, exchange traded investment products. It also shows that investor demand can also be met by similar products like ETPs that do not rely on payment of stamping fees.

63) LICs, LITs and ETPs are appealing to consumers as they are all easily accessible through an exchange market, the prices are transparent, and they provide diversified exposure to domestic and international equity and debt products (albeit, ETPs appear to offer greater diversity in underlying assets). **Figure 9** shows that:

a) around 90% of the market capitalisation of LICs and LITs is invested in equities (around 60% in Australian equities). The remainder are mostly part of a growing segment in fixed income and property products

b) around two thirds of the market capitalisation of ETPs are invested in equities (around 28% in Australian equities). The remainder are a diversified mix of fixed income, commodity, currency and property/infrastructure products.

Figure 9: Asset Spread of LIC and LIT vs ETPs



Source: ASX Investment Products Report December 2019

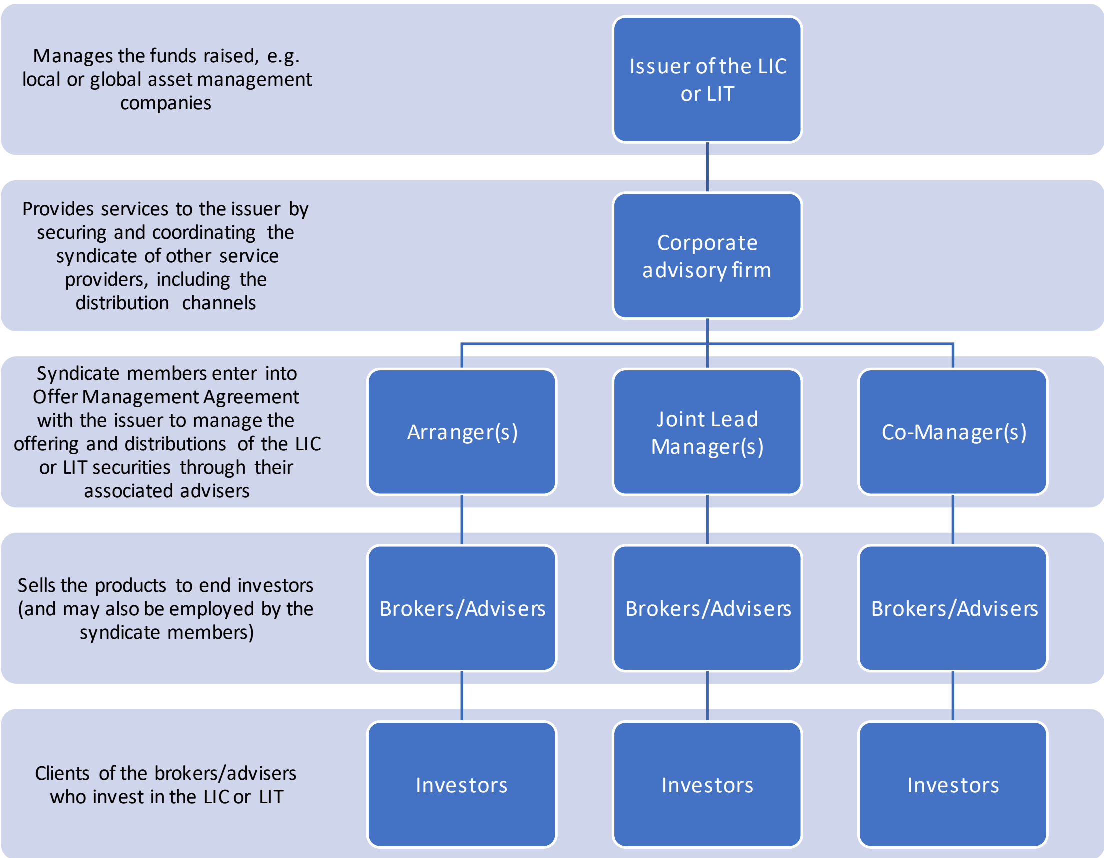
64) LIC and LIT-style products are popular abroad, particularly in the US and UK. Market capitalisation of closed-end funds in the US is around $USD275 billion and in the UK around £200 billion, both representing markets around six times the size of the Australian market. In the UK, commissions are banned on the sale of investment products, including LICs, but it has not deterred new issuances. A similar number of LICs have been launched recently in the UK as in Australia (27 in the UK in the last two years compared to 20 in Australia), reflecting the underlying demand for these types of products, and suggesting that they can successfully launch without the need for commissions.

ATTACHMENT B: DISTRIBUTION AND FEES FOR LICS AND LITS

65) Our supervisory work has enabled us to observe how LICs and LITs are distributed by firms in the Australian market, including the impact of various advisory fees. Through such fees and commissions, licensees, including stockbrokers and other financial advisers, can earn substantial revenue from successful LIC or LIT issuances.

66) Typically, there are a small group of intermediaries who provide any or all services needed for the delivery of IPOs, including legal, marketing material, strategy, syndication services and linking fund managers to distribution networks. These intermediaries liaise between the issuer and a core group of fewer than ten licensees, most of whom are stockbrokers with access to client distribution channels who often act as a manager, JLM, co-manager and/or arranger in these transactions (jointly known as the syndicate). Issuers are typically Australian or global asset managers. **Figure 10** shows the typical relationship between the various parties, although firms may perform multiple roles in this chain. The role that each party plays in the development and distribution of a LIC or LIT is typically not fully disclosed in the public offer document, but rather under a confidential Offer Management Agreement between the issuer and the syndicate.

Figure 10: Roles of the Various Parties in a Typical LIC/LIT Issuance



67) We have observed that distribution of LICs and LITs are primarily to retail clients, although there is increasing interest from self-managed super funds that may be classified as wholesale clients. Many stockbrokers distribute products solely to their own individual client base, while some others have relationships with financial adviser networks and distribute via those external

avenues, depending on the licensee's business model. The LICs and LITs are usually recommended through general or personal advice, dependent on the firm's business model.

68) The example below illustrates the common types of one-off initial fees and ongoing fees that we have observed for a capital raising of $750 million.

Example 2 - Fees on a typical LIC/LIT capital raising of $750 million

One-off fees:	
Lead Arrangers:	Share of 0.4% of total raised or $3 million
Joint Lead Managers:	Share of 0.8% of total raised or $6 million
Brokers/advisers (stamping fee):	1.25% of value raised or $9.375 million
Ongoing Annual Management Costs:	0.85% or $6.412 million pa comprising:
Fund Management Fee:	at 0.70% of NAV p.a.
Responsible Entity Fee:	0.025% of NAV p.a.
Admin fee:	0.125% of NAV p.a.

69) In comparison, an ETP is launched as an open-ended offer with units freely able to be issued or redeemed on an ongoing basis. Ongoing annual management costs for ETPs can vary but are generally between 0.05% and 1% of assets under management. There has been limited issuance of new REITs in recent years. Recent REIT issuances have typically been secondary issuances that have been underwritten and so have quite different distribution structures than for primary issuances of LICs and LITs.

70) The terms of the Offer Management Agreements themselves can also create a conflict between consumers' interests and the syndicates obligations as these agreements regularly contain clauses requiring the syndicate members to procure applications from their clients. This is particularly the case where there is no cap on the amount of capital raised. For example, it is common under these agreements that the syndicate members 'must':

a) assist the [issuer] … in marketing the Offer to potential investors; and
b) use their reasonable endeavours to procure subscriptions for the offer from investors.

71) We have also observed examples of agreements where the percentage fee paid increases if certain goals are met in 'raising assets'. That is to say, the percentage of the stamping fee is not fixed but increases the more the co-manager is able to sell. This can exacerbate the conflict by incentivising the co-manager to sell more of the product.

72) We have observed a great deal of variability in the level of due diligence[3] on the structure of LICs and LITs, their viability and features conducted before agreement is reached to act in a

[3] As explained in ASIC REP 484: *Due diligence practices in initial public offerings*, due diligence is a process adopted by issuers to determine whether they have properly prepared a prospectus offering securities to retail investors. The process is designed to ensure the prospectus contains accurate information and has not omitted any material information. Corporate advisers and lead managers of the offer help coordinate the preparation of the prospectus and participate as a member of the due diligence committee in its deliberations on the

syndicate. There have been instances where a LIC or LIT is rejected at the due diligence stage by one prospective syndicate member (e.g. due to concerns around the managers, conflicts, excessive fees, including stamping fees), but other firms have facilitated the offer.

73) We have observed instances where retail investors can suffer further detriment by paying higher management fees than wholesale investors and consequently subsidising the management fees paid by wholesale investors. Some offers allow wholesale investors to access ‘differential fees’ whereby they are given rebates (to effectively lower the ongoing management fee). Access to differential fees is available to wholesale investors but not to retail investors.

contents of the prospectus, in addition to providing the issuer with assistance on the marketing of the offer. Advisers are responsible for various aspects of the due diligence process.

ATTACHMENT C: RESPONSE TO PUBLIC COMMENTARY ON INITIAL ANALYSIS ON LICS AND LITS

Elements of ASIC's initial analysis on LICs and LITs was made public following a Freedom of Information request at the end of 2019. Below, we respond to some of the public comments on it.

Commentary	Response
ASIC analysis didn't recognise the value of free options attached to LIC issuances	While some LIC issuances may have options attached, they may benefit the issuers rather than investors. Exercising the LIC option require additional investment by the investors, while increasing the LIC's assets under management and thereby increasing fee revenue. The additional investment results in no additional returns to the investor, and proportional dilution if all shareholders exercise the option and disproportional dilution to shareholders who do not wish to exercise the option and invest more funds.
"Pirate Funds" should be excluded from the sample as outliers	It is highly likely that the payment of high stamping fees supported the raising of funds by some LICs that have since been delisted. Therefore, they are relevant to the consideration of stamping fees. We have updated our analysis where appropriate to use averages and medians to address outliers.
ASIC's analysis didn't recognise the value of franking credits and tax benefits of LICs to clients	We do not consider the difference in percentages of franking credits of LICs vs other investment structures is significant enough to compensate for the relative underperformance and discount to NTA. See paragraphs 43) to 46) of this submission.
Underperformance in LIC and LIT unit prices driven by higher discounts to NTA for LICs and LITs	The cause of the underperformance is irrelevant in assessing the impact on investors who sell out of a position at a higher discount to NTA. Due to the closed-end structure of LICs, investors who bought into the LIC at IPO at full NTA can only exit at the secondary market price which often is at a discount.
Performance drag in some instances is caused by investors bearing the cost of issue (including stamping fees) by paying a premium to NTA on certain IPOs	Performance drag, to the extent that it still occurs, results in an even worse fundamental outcome for investors.
ASIC's analysis is based on mid 2019 data when there was uncertainty around franking credits. Since then many LICs have rebounded	We have updated our analysis to include data through to end 2019 and reflected the updates in this submission. The market movements in the second half of 2019 did not materially impact the underperformance of these products and most still trade at a discount to NTA.
Investors can profit from buying 'undervalued' LICs trading at discount to NTA on secondary market	Our analysis has been focussed on the impact of stamping fees on outcomes for consumers that buy at the IPO stage (the point the stamping fees are paid). It highlights the importance of advisers considering whether to recommend that clients invest in these products during the initial capital raise or after a period on the secondary market.