21 February 2020

The Treasury

Langton Crescent

PARKES ACT 2600

By email: stampingfeeteam@treasury.gov.au

Dear Sir/Madam

Re: Consultation on the Stamping Fee Exemption

The Australian Financial Markets Association (AFMA) welcomes the invitation to provide comment to the Treasury on the merits of the current stamping fee exemption in relation to Listed Investment Companies (LICs) and Listed Investment Trusts (LITs).

AFMA is an industry representative body whose membership includes 110 firms active in the financial markets and wholesale banking.

Capital raising is one of the most important functions of the financial markets and is vital to a well-functioning economy. It is critically important that firms and governments continue to be able to access product management and distribution.

Raising capital entails a process that includes significant work and risk being undertaken by the industry and its professionals. In a market-based economy, firms will charge for undertaking this work and associated risks, and some of this work will entail conflicts that need to be managed appropriately.

There are already significant measures in place to ensure these conflicts are appropriately managed. AFMA is concerned that attempts to entirely remove, rather than sensibly manage, conflicts can result in economic distortions. The removal of stamping fees for LICs and LITs could effectively remove access to a flexible investment capital raising mechanism, close the sector to new entrants, and lessen the availability of a range of investment options (notably international fixed interest) that include many high-quality names and strategies, and provide welcome diversification for retail investors.

If there are issues with inappropriate selling of LICs and LITs, then AFMA supports the management of these issues in a targeted and proportionate way that does not risk damage to Australia's

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, Angel Place, 123 Pitt Street GPO Box 3655 Sydney NSW 2001 Tel: +612 9776 7900 Facsimile: +612 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

capital raising infrastructure. We would suggest that government mandated fixing of the stamping fees at zero for these products would not be sufficiently targeted nor proportionate.

More generally, AFMA supports allowing the various mechanisms of the market to work to address discounts to NTAs rather than government intervention.

Please find our more detailed response attached to this letter.

We note also our concerns about the accelerated pace of the current policy review process. Good policy making takes time and there is a risk that a shortened response period may be more likely to lead to less well-informed choices.

We trust our submission is of assistance and would be pleased to continue to contribute to the Government's review of the matter. If you require further assistance in relation to our response, please do not hesitate to contact me via the Secretariat.

Yours sincerely

Damian Jeffree

Senior Director of Policy

Detailed Response

Benefits of capital raising

Capital raising through the financial markets is a critical function in market-based economies and is of direct benefit to companies, investors, governments and the broader economy.

The contribution of retail investors to capital market raising overall is significant, but will vary for different capital market products and the economic period and investor appetite in which the raising takes place.

The stamping fee exemption facilitates the wide distribution of capital raisings to retail investors. Capital raisings can be very work-intensive undertakings, particularly in the case of large placements and privatisations. The considerable amount of work by firms involved benefits those seeking to raise the funds, the companies involved, the owners of the companies (including from time to time the Government through privatisations), and the retail investors who are able to gain exposure to a wider range of investment opportunities.

The products to which the stamping fee exemption applies have continued to serve the economy well, providing ample capital to companies, to banks through hybrid issues, to fund managers through LICs and LITs, and to real estate managers through the Real Estate Investment Trust (REIT). They have also benefited infrastructure owners and projects with the provision of capital through infrastructure securities, and to governments through privatisations.

AFMA cautions against impacting these capital raising activities. LICs and LITs, as we argue in this submission, provide a convenient way for investors to access global debt funds and a range of other investments. While their loss would be regrettable and create inconsistencies, it would be unlikely to significantly damage the economy.

Removal of the stamping fee exemption for the other products we have listed, however, could risk more significant economic harm. We caution against interfering with the ability of the private sector to raise capital through regulatory fixing of the price for these services at zero in a market-based economy.

REITS, Infrastructure and Stapled Securities

AFMA is concerned with ensuring that REITS, infrastructure securities, and 'stapled' securities that include an ordinary share paired with a REIT or infrastructure security, are not affected by the proposed changes. While legally similar in structure to LICs and LITs, these securities are inherently defensive and are generally lower beta, more stable investments.

Since their introduction to Australia in 1971, these structures have made substantial contributions to the raising of capital for the provision of important infrastructure, such as roads and real estate developments including shopping centres, commercial buildings, housing, and manufacturing and distribution centres. As an example, GPT, the first Australian REIT, now has $25 billion[1] worth of assets under management. Australian REITs as a group have had an annualized return of 12.57%

[1] https://www.gpt.com.au/sites/default/files/2020-02/Annual%20Financial%20Report%20%5BGPT%5D%20-%20GPT%202019%20Annual%20Result.pdf

over the last 10 years with an annualized risk of 11.54% over the same period[2], and are capitalised at around $140 billion[3]. This represents a sizeable contribution to Australia's development.

Similarly, with regard to infrastructure securities, we note that the stapled securities arrangement has been a strong contributor to the PPP model of development in Australia. Its track record and ongoing potential is recognised in legislation,[4] in some cases creating nationally significant infrastructure that significantly enhances the long-term productive capacity of the economy.

If the stamping exemption is no longer extended to firms that invest in the manner of LICs and LITs it is important from an economic viewpoint that at least the productive raising of capital for retail and infrastructure investments is allowed to continue.

Bank Hybrids

AFMA also notes the importance of retaining the ability of the banks to raise capital through hybrids. These structures have played an important role for banks in recent years in raising the increased capital that has been required by regulators. They have also been attractive to investors seeking enhanced returns from well-established companies with which they are familiar. The current access structures are convenient and efficient for retail investors.

We oppose any proposal to restrict access to bank capital raising in relation to hybrids through stamping fee changes. Any considerations in this regard should require the concurrence of the prudential regulator given the prudential implications.

Review of concerns raised

AFMA's starting position is that there is nothing inherently wrong with closed-end investment products which are listed on exchange. To the contrary, these products are particularly well suited to some asset types, have some inherent efficiencies, and are preferable to some unlisted vehicles as they provide the convenience of public liquidity for investors and the discipline and transparency of public pricing.

Efficiencies inherent in the structures include that:

- a fixed asset pool does not require provisions be made for redemptions;
- there is no risk of a redemption spiral;
- administration is internal, so costs can be kept low in well managed entities;
- listing structure allows ready entry and exit without delays. For secondary market trading entry this requires no additional paperwork;
- there is an ability to smooth returns and frank dividend returns directly in some circumstances; and
- active management allows the potential for alpha on returns.

[2] https://us.spindices.com/indices/equity/sp-asx-200-a-reit-sector
[3] *Ibid.*
[4] Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019.

LICs and LITs provide a flexible platform enabling investors to access a wide range of domestic and international products, providing the opportunity for portfolio diversity through structures that are convenient for investors.

As there are a range of products that these entities invest in, treating them as a homogenous class for policy purposes may be misleading.

Some of these products are complex and may not be suitable for all investors, however, even products that have higher risks or are more complex investments can form a valid if smaller part of an investment portfolio.

The current listed investment companies on the ASX invest in a range of products, including:

- Australian shares, principally ASX-listed shares;
- international shares, principally international listed shares;
- private equity funds, which invest in unlisted domestic and international companies; and
- specialist funds which invest in particular assets or investment sectors[5].

Some LICs are conservatively invested, whereas others are higher risk, but may also offer the potential for higher returns.

We understand that concerns have been raised internally by ASIC in relation to the performance of LICs and LITs based on their performance over the year to August 2019 and the 4.7-year period[6] to August 2019, creating a concern that higher stamping fees have been associated with poorer performance.

We understand the research by ASIC was prepared for internal purposes and not for public release, as such we caution against its use as a basis for policy decision making, given it may not yet have been subject to full development and the usual checks and testing that would accompany a public study.

ASIC has recently proposed that product issuers be required:

> [when] reviewing a target market determination, we expect the issuer will take into account all available information on its financial product, using multiple data sources.[7]

This approach would also be of benefit to the processes used for internal assessments by ASIC, particularly where these are to be shared with other departments. AFMA has found there are inconsistencies in the data provided by different sources[8] in relation to LICs and LITs that require careful resolution before producing a final analysis.[9] We support the view that the use of all available information from multiple data sources can assist in reducing data integrity issues.

We also note the issues with point-in-time analysis. A better approach would be to continue to monitor the sector over a period of time. Many of the particular issues that might be colouring performance at a particular point might then be less likely to skew the analysis.

As the report is now in the public domain and informing debate we respond below to the findings:

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[5] Source: ASX.

[6] The ASIC paper refers to this 4.7 year period as a five-year period.

[7] ASIC CP 325 p. 31, https://download.asic.gov.au/media/5423121/cp325-published-19-december-2019.pdf

[8] For example, out of date NTA data.

[9] Others have also raised data concerns see: https://www.livewiremarkets.com/wires/the-lic-lit-mis-selling-crisis-is-grossly-exaggerated

- **Poor performance of LICs and LITs, significant proportion had negative returns (including two delisted due to fraud). Overall -6.1% since inception, -6.3% for recent year**

ASIC's report has been used to call for changes to the issuance of all structures of this type, but the data used is limited to a select subset of the listed investment space that includes only companies and trusts that have listed since 2015. We note that this excludes the most established and some of the most successful listed investment companies such as AFIC, Argo, Milton Corporation and WAM. AFIC notably has been investing since 1928, Milton since 1938 and has been listed since 1958.

Listed investment companies alone have, over the course of the last 60 years, evolved to attract $53 billion worth of investments[10], which suggests the structure has performed well over the long term.

Selecting a 4.7-year period for analysis for this small subset (by capitalisation) of the market and giving significant weight to the performance of those entities in a single year may not be a sound basis for proposing changes that would affect the whole sector on an ongoing basis. The period, while significant, does not sufficiently cover a full market cycle, and covers a period of relatively benign growth on the local market that might favour passive index-following strategies ahead of active or more defensive strategies. We note commentary suggesting that part of the current underperformance relative to NTA may be attributable to uncertainty related to proposals prior to the federal election relating to changes to franking credits.[11]

As noted, the ASIC analysis also gives emphasis to recent year performance. For long term investments this may not be an appropriate approach. In financial markets it is not uncommon for different product classes to perform better or worse as a group over an extended period. For example, from the time of the 2007-08 Financial Crisis, the main share index produced negative results over the 5 year and 1-year periods to 2012, before recovering recently to trade at all time highs. A period of underperformance should, as a general rule, not invite regulatory intervention to limit further investment.

We also caution against drawing conclusions from averaging the returns of such a diverse range of investments that are represented by LICs and LITs. As noted, these investments range from conservative to higher risk strategies across a range of asset classes. As such their return as a group will depend as much on the mix of asset classes targeted as it would on the outcome of the mix of strategies within each asset class. This mix will change over time, and since 2015 has trended more to issuance of international debt related securities.

We note that gaining an accurate view of the LIC and LIT sector should also take account of capitalisation weighting to give an accurate picture of the returns. The ASIC returns do not appear to be weighted with the one-year figure being a simple average.

- **Large discounts to NTA, averaging -10.7%. 42 out of 48 issuances since 2015 trade at discount to NTA**

There are market mechanisms to address entities that trade at a discount to NTA, including on-market buy-backs, mergers, acquisitions, investment manager changes and restructuring,

[10] Source: Morningstar https://cdn.morningstar.com.au/mca/s/documents/201912_ASX-LIC-NTA-Report.pdf
[11] https://www.etfwatch.com.au/has-uncertainty-around-franking-credits-taken-the-shine-off-lics/

including conversion to trust structures etc. In the extreme, investors can push for delisting, whereby they can expect to realise value closer to NTA.

Over the course of time, even successful funds can have periods of cyclical discounts as well as premiums to NTA, see Figure 1. A period of under NTA performance may be reflective of broader market conditions rather than any specific failing of an investment structure.

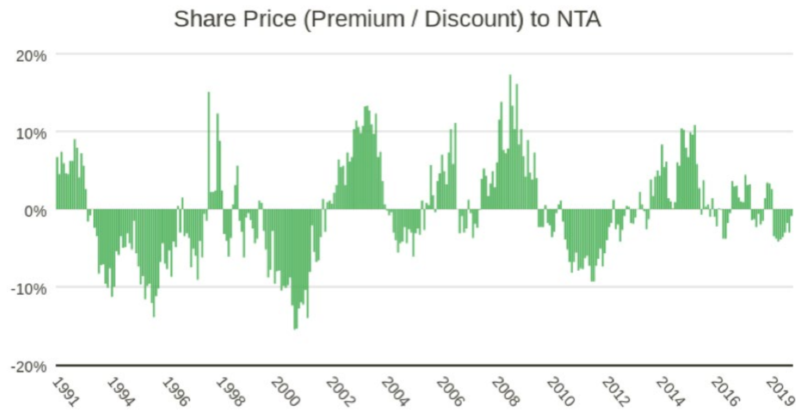

Figure 1: Argo Investments Premium Discount to NTA (source Argo)

Since the point-in-time the report was published there has been some improvement in NTA ratios and two thirds of large LICs (>$1 billion capitalization) are now trading (as at 31/12/2019) at a premium to NTA, see Figure 2.

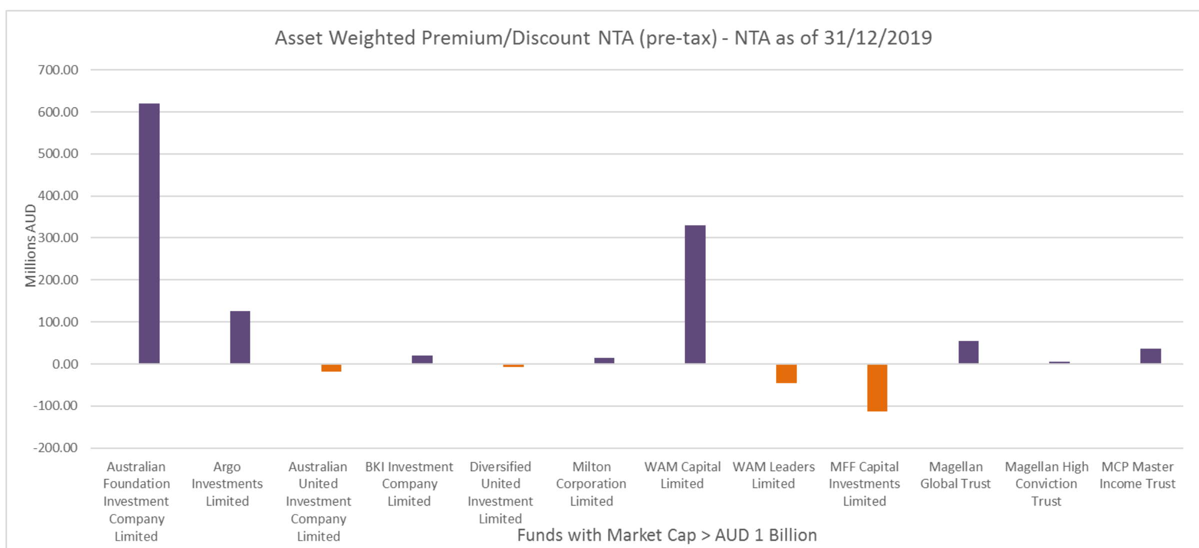

Figure 2: Large LICs Asset Weighted Premium/Discount

- **Higher fees charged by LICs and LITs than ETFs and ETP Managed Funds, while significantly underperforming on average**

Higher fees are charged by LICs and LITs as they are not passive investments and therefore have higher cost bases to cover the associated funds management. This is not unique to listed securities and is exactly the same for unlisted funds.

Investors see value in the investment management services, provided they expect that these fees will be offset by additional gains. While fees are paid by investors in listed and unlisted investments with an intention that they will result in excess returns, there is no guarantee this will eventuate. This is a risk best managed by financial advisors and investment analysts, given their specialisation in this field, rather than at the regulatory level.

In addition to the benign index growth qualities of the period, these years have also been part of a multi-decade shift from active to passive investment, a shift which in turn may itself assist returns from passive investment strategies. However, this does not provide support for government intervention to drive more funds into passive investments. Indeed, academic work by the Federal Reserve has suggested eventually that the shift to passive strategies might be expected to boost the profitability of active investing strategies relative to passive investments.[12]

As ASIC noted in *Reg Guide 53 The use of past performance in promotional material* the use of past performance may be misleading as a way of estimating the "likely future value of an investment" or if it is used "in a way that creates the impression that substantially the same returns will be achieved in the future"[13]. By the same logic, we caution against extrapolating more recent performance into long term performance.

We note also that there may also be systemic benefits in keeping a balance of funds invested between active and passive strategies. [14]

- **Conflicted remuneration, 42 out of 48 LICs and LITs issuances since 2015 involved stamping (selling) fees**

See the *Services associated with IPOs* section that follows.

- **Higher stamping (selling) fees are correlated with worse investment returns and bigger discount to NTA**

The chart used to support this finding by ASIC is below in Figure 3.

[12] Anadu, Kenechukwu and Kruttli, Mathias S. and McCabe, Patrick E. and Osambela, Emilio and Shin, Chaehee, The Shift From Active to Passive Investing: Potential Risks to Financial Stability? (December 17, 2019). P. 22. Available at SSRN: https://ssrn.com/abstract=3244467 or http://dx.doi.org/10.2139/ssrn.3244467
[13] See 8.1 Reg Guide 53 *The use of past performance in promotional material,* https://download.asic.gov.au/media/1238984/rg53.pdf
[14] Anadu, *et al.*, p. 27.

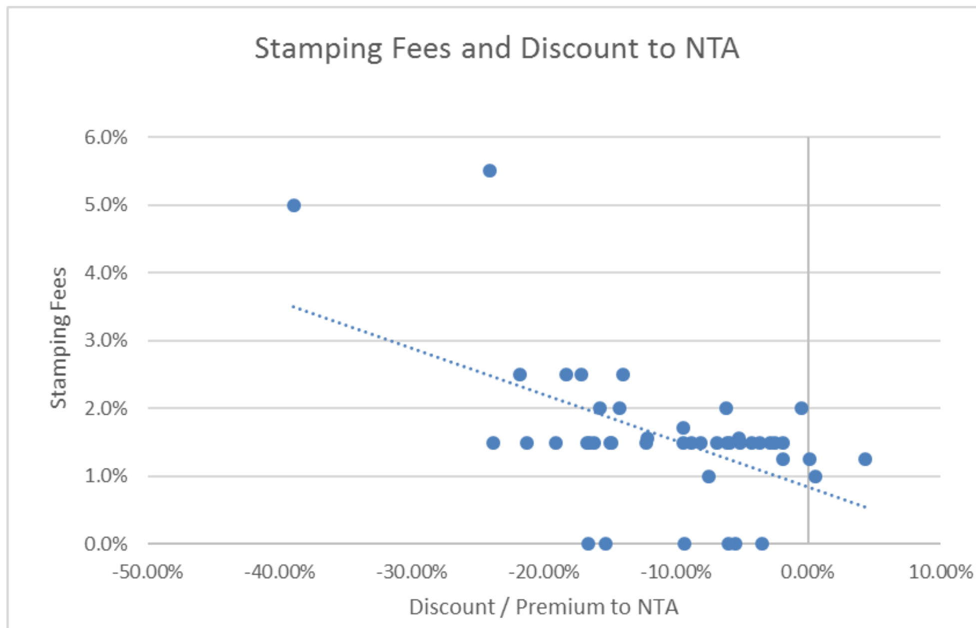

Figure 3: ASIC Analysis

ASIC's unweighted trend analysis is heavily dependent on two data points (MMJ and LRT). These appear to be outliers in relation to both their stamping fees at 5% and 5.5% respectively and their discounts to NTA at 39% and 24 % respectively. Additionally, as can be observed from Figure 4, these are small issues in comparison to the bulk of the sector.

Note that as the trendline ASIC has used is not weighted to issue size, it will be equally affected by these small securities as by the much larger securities.

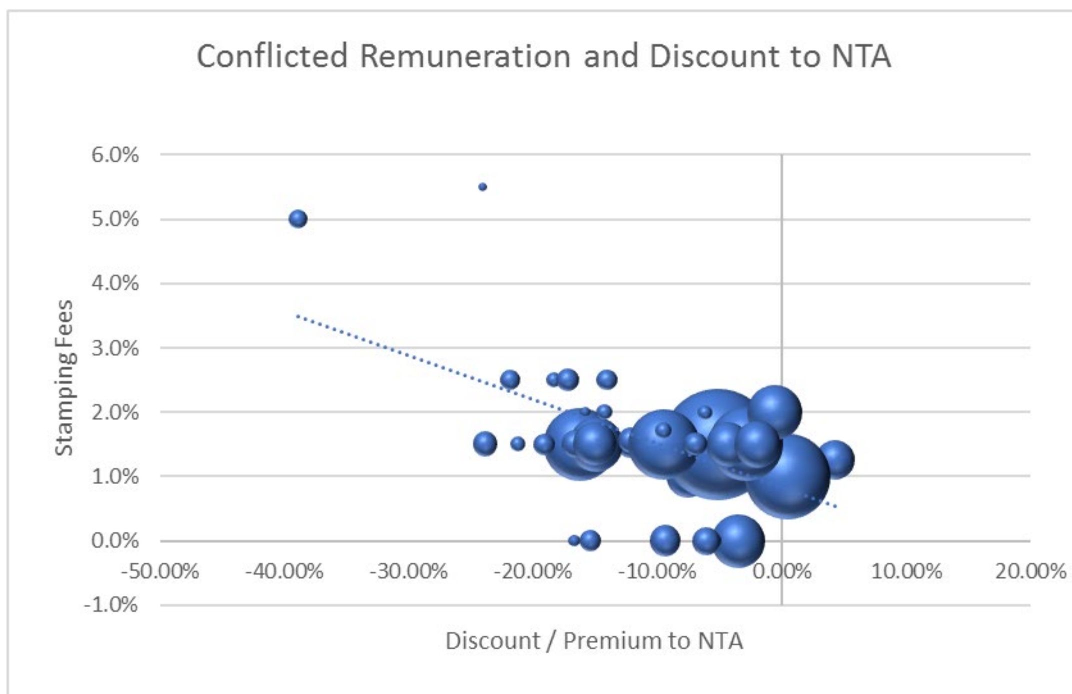

Figure 4: ASIC Data (Bubble size = Market Capitalisation)

Excluding these two securities, the correlation of fees with investment returns significantly reduces the observed trend, see Figure 5. ASIC's finding that "Higher stamping (selling) fees are correlated

with worse investment returns and bigger discount to NTA" is highly dependent on these two outliers. We suggest it may not be appropriate to make changes that would impact all investments utilising these structures based on conclusions drawn from the effect of these two data points.

We note by inspection that the bulk of issuances are around 1.5% stamping fee.

More targeted measures may include a safe-harbour approach to fee guidance where stamping fees at or below a certain level (for example 2% or 2.5%) might be assumed to be appropriate. A 2% cap would further flatten any residual trend. Higher levels might attract an 'if not, why not?' approach from regulators.

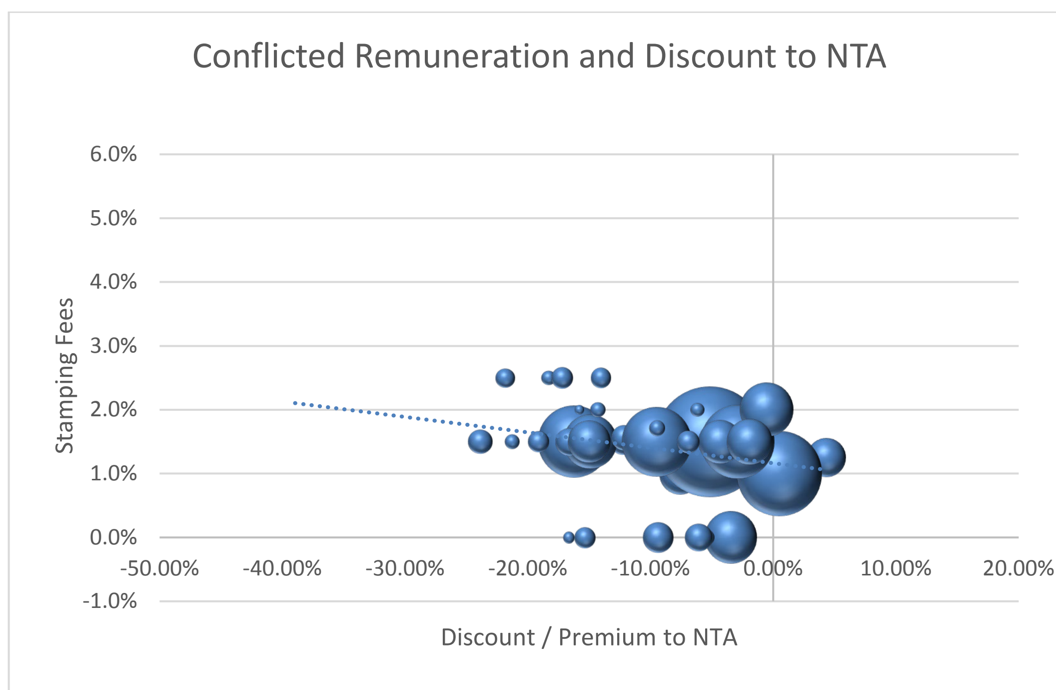

Figure 5: ASIC Analysis excluding. ≥5% outliers

In the summary table ASIC appears to have used simple averages[15]. This approach might not provide an accurate picture of the sector as a whole, as it accords as much weight to small outlier securities as it does to larger more mainstream securities. A fairer view of the investment class, particularly if wholesale changes are proposed or contemplated, would reflect the distribution of invested monies in the structures.

- **LICs and LITs with stamping (selling) fees underperform LICs and LITs without stamping (selling) fees on average**

The small sample size of six for the zero stamping fee securities is not sufficient to reliably make policy for the sector.

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[15] See page 3 Summary Statistics for LICs/LITs in *Review of LICs and LITs Market and Conflicted Remunerations.* For some figures we would require further information to understand their derivation.

Services associated with IPOs

There are several service providers that are typically engaged by an issuer for an IPO. Each provider performs a distinct function and will be paid a fee for their services, as outlined briefly below:

- (Joint) Lead Arranger fee – fees for the lead arranger (or joint lead arrangers) to provide advice to the issuer, including on the overall coordination and management of the IPO process;
- Joint Lead Manager fees – fees for the joint lead managers (including the arrangers, collectively referred to as the "syndicate panel") to provide advice on the structure, timing, strategy, documentation and other associated investment-banking type services; and
- stamping fees – fees paid to brokers and financial advisers for the distribution and associated processes in an IPO.

AFMA notes that the fees paid to the joint lead arrangers / joint lead managers for their services are distinct to the distribution of the product and the stamping fees. We note that the legislation currently does not distinguish between this mix of fees categorising them all under the outmoded term 'stamping fees'.

We would suggest that if changes are made to the stamping fees these should not affect the arranging and management fees. The arranging and management fees are associated with investment banking work including strategy, timing, and execution of these plans.

AFMA opposes the removal of the stamping fee exemption on these products for the same reasons we oppose the removal for other products within the exemption's scope. Specific to the distribution related stamping fees, the distribution and associated processes in an IPO require effort and risk, so it is appropriate in a market economy that fees are payable for these services. Fixing of prices to zero for these services is likely to distort the market.

Furthermore, AFMA notes that characterisation of the fees as 'selling' fees in the ASIC materials may be misleading. Stamping fees cover a range of activities to support a retail distribution of a LIC, LIT, REIT, Hybrid or Equity IPO including:

- due diligence and review of materials relating to the product raising;
- managerial compliance around the product release process, including consideration of entry onto restricted lists;
- review and rebalancing of model portfolios/asset allocation models;
- preparation of launch materials, standard emails, and the briefing of advisors;
- preparation of Statements of Advice and Records of Advice;
- application form completion (these are often by the advisor acting on instruction from the client);
- due diligence in relation to each involved client;
- communication with individual clients – this can include multiple consultations with clients and be more extensive for more complex products; and
- confirmation letters to each client advising of allocation.

In some instances, work will be undertaken, but the product will be found to not be appropriate for distribution and so no fees will be collected.

Artificially setting the cost of these services to zero is not appropriate in a market-based economy and will introduce unwanted distortions, including but not limited to, effectively closing off a flexible avenue for globally connected diversified investment.

Firms should of course be free to compete and for investors that value a fixed or other fee arrangement this can be supplied by firms through the market mechanism of competition.

Management of conflicts to avoid distortions

We caution against trying to eliminate all conflicts but support the appropriate management of these conflicts. Removing conflicts completely is often not possible in market-based economies without introducing significant distortions and inefficiencies. Addressing these distortions was the motivation for extending the exemption to LICs and LITs in 2014:

> This amendment also addresses concerns that **the current regulation creates an inappropriate, market-distorting distinction between the types of entities that are otherwise legitimately permitted to raise capital from retail investors.** The current regulation prevents investment entities (that is, entities whose primary purpose is to provide a financial investment) from accessing the stamping fee provision. This amendment clarifies that, where stamping fees are paid to facilitate capital raising activities involving certain approved financial products, these fees are not captured by the ban on conflicted remuneration—including where these fees relate to capital raising activities undertaken by investment entities.

Advisors have an obligation to act in the best interests of their clients and if they fail to do so they should be subject to appropriate sanction. We note the recently commenced FASEA Code of Conduct which reinforces this requirement.

Where the investments offered by LICs and LITs are higher risk, noting this is dependent on the details of the individual security, it may be appropriate for retail investors that this is limited to a small part of their investment portfolio.

These measures are examples of appropriate ways of managing the conflict, particularly if combined with safe harbour provisions that ensure appropriate scrutiny for excessive stamping fees.

Reduced retail investment options

A key outcome of removal of the stamping fee exemption for LICs and LITs will be reduced and less convenient access to investment options for retail investors. In recent years LITs have provided a convenient way of accessing globally diversified fixed income investments with four debt related listings in 2019 up from three in 2018 raising a total of $3.5 billion over the period 2017 to 2019[16]. Participating in these raisings were global brands Neuberger Berman, Partners Group and KKR. Further listings have been flagged by CVC, Credit Partners and Guggenheim.

As an example of what could accompany removal of stamping fees, PIMCO, a highly respected fixed income manager, who manages $1.9 trillion USD in assets globally, planned to list a bond fund on the Australian market in February 2020, its first for the Australian market, but this has been put on hold pending the outcome of the current review[17]. PIMCO is supportive of paying appropriate fees for the services of distribution, as it does not have a large existing direct retail client base to draw

[16] https://www.firstlinks.com.au/article/fewer-lics-lits-2019-more-funds-raised

[17] https://www.afr.com/markets/debt-markets/pimco-freezes-bond-fund-ipo-on-commission-review-20200131-p53wn2

on for distribution in Australia. It is inefficient to require each fund to build its own direct retail relationships through advertising, sponsorship and the like in each market. It is more economically efficient to allow some firms to specialise in this activity.

If this issue does not proceed, Australian investors may have less access to the global debt opportunities offered by one of the world's leading managers. Many market analysts have suggested Australian investors are currently under-exposed to fixed income and related investments, and there have been reports of strong demand for the debt-related issuances.

Ready access to diversification of investments is a key benefit offered by LICs and LITs to retail investors and the closing off of a publicly listed avenue to this end should require a compelling case. In our view this case remains to be made.

Curtailing further development of the LIC/LIT sector

The PIMCO suspension suggests a ban on stamping fees may risk closing the structures to new entrants, even those of PIMCO's size and reputation. The sector might remain open only to incumbents with large investor bases they can contact in relation to new issues. This creates a barrier to entry to competition in these structures and is not an economically efficient outcome.

While it may initially be of benefit to these incumbents, over the longer term it may diminish interest in the sector as a whole. The unlisted sector would also benefit from the decrease in competition from the listed space.

Conclusion

In conclusion, AFMA holds that the LIC and LIT structures have proven themselves over the long term and continue to develop, attracting investor interest and providing welcome portfolio diversity by offering ready exposure to a wide range of domestic and international investments at a variety of risk levels.

We do not support intervention to set prices at zero for the services associated with lead arrangement, management and retail distribution as this may risk removing a valuable capital raising mechanism and a varied investment option for investors.

We are concerned that the data used for the analysis is limited and may not be suitable as a basis for the changes being considered. Proceeding on the basis of the analysis presented may be precipitous.

AFMA supports consideration being given to greater regulatory scrutiny of outlier stamping fees, and ensuring that advisors are meeting their obligations to act in investor interests when recommending products. These are targeted and proportionate ways to ensure that these structures are being used appropriately.

If a decision is made to remove stamping fees for LICs and LITs this would be unfortunate policy as it would not be a proportionate response to a reasonable view of the evidence and would remove valid options for retail investors. AFMA is more concerned, however, that the extension of a ban to other products could risk real economic harm as it could inhibit the proper functioning of the capital raising infrastructure.