SQUIRE PATTON BOGGS

FINANCIAL SERVICES UPDATE

July 2015

In this Financial Services Update, we look at:

- **Opportunities under the China Australia Free Trade Agreement:** On 17 June 2015, the China Australia Free Trade Agreement (**ChAFTA**) was signed by Australia and China. In this article, we look at what opportunities this may bring for Australian financial service providers.
- **Updates to financial reporting relief guidance for managed investment schemes**: ASIC has released an updated Regulatory Guide 174 accompanied by Corporations (Externally-Administered Bodies) Instrument 2015/251, providing financial reporting guidance (and relief) for the winding up of distressed managed investment schemes.
- **Superannuation governance shake-up**: the Federal Government has released exposure draft legislation which will require APRA regulated superannuation funds to have a minimum of one-third independent directors on their trustee board and an independent chairperson.
- **FINTECH on the rise**: Australian financial technology (or FINTECH) (also known as disruptive technology in financial services) businesses and companies are finally gaining a profile in 2015. In this article we look at the recent developments in FINTECH.

Opportunities Under the China Australia Free Trade Agreement

On 17 June 2015, the China Australia Free Trade Agreement (**ChAFTA**) was signed by Australia and China. The free trade agreement, which is expected to come into effect in January 2016, significantly improves access to the Chinese market for Australian exports in agriculture, energy and resources and professional services. Australian financial service providers are a major beneficiary, with ChAFTA including provisions to grant greater access to key Chinese markets, which are unmatched and unprecedented in any other free trade agreement.

In this article, we highlight some significant outcomes in the ChAFTA for Australian financial service providers.

Funds Management

Australia has been granted a 50 billion renminbi (**RMB**) quota under China's RMB Qualified Foreign Institutional Investor (**RQFII**) program, allowing Australian financial institutions to invest offshore RMB denominated currency in Chinese onshore financial instruments. This will allow Australian domiciled fund managers to purchase equities and bonds directly from China's mainland securities exchanges in Shenzhen and Shanghai, including China A shares, which are currently exempt from capital gains tax. Australian fund managers will also have access to stock index futures and Chinese fixed-income products traded in the inter-bank bond market, although the latter will require approval from the People's Bank of China prior to trading. While the recent volatility of Shenzhen's and Shanghai's stock markets will likely discourage Australian fund managers from entering this market in the near term - in particular having regard to the impact on confidence in stock trading (the collapse in early July has been said to have wiped out more than AU$2.4 trillion in wealth[1]) and the immediate regulatory intervention imposed by the Chinese Government capping short selling, suspending IPOs and arranging for a broker-led fund to acquire shares backed by central bank funding – these benefits to Australian fund managers should offer opportunities over the longer term.

Under ChAFTA, Australian securities brokerage and advisory firms will also be permitted to provide cross-border securities trading accounts, custody for overseas assets, and portfolio management services to Chinese Qualified Domestic Institutional Investors (**QDII**) i.e. Chinese institutional investors will be permitted to invest offshore.

Securities and Futures

For the first time in any free trade agreement China has entered into with any other country, Australian financial service providers will be permitted to establish joint venture futures companies, or joint venture securities companies in China, with up to 49% Australian ownership. Under the terms of the ChAFTA, joint venture securities companies will be permitted to engage in securities brokerage, proprietary trading and asset management domestically. Australian securities firms will also benefit from the raising of foreign equity limits to 49% for participation in the underwriting of domestic A and B shares as well as H shares listed on the Hong Kong exchange, and ChAFTA guaranteeing the ability to conduct domestic securities funds management business.

In addition, Australian financial institutions will be extended non-discriminatory treatment as a foreign entity for approved credit asset securitisation business in China. As a result, Australian bank subsidiaries will be the first foreign banks in China eligible to engage in credit asset securitisation.

1 'China's unsettling stock market collapse', 4 July 2015, The Atlantic

Banking

Australian banks will benefit significantly under ChAFTA. China has reduced the waiting period for Australian banks to engage in RMB denominated business from three years to one year, and removed the two year profit-making requirement as a precondition to the provision of domestic currency services in China. Australian bank branches in China are also exempt from the minimum working capital requirement of RMB 100 million per branch. Finally beachhead provisions will facilitate a more streamlined approval process for Australian banks already established in China with permission to engage in currency banking business to establish further bank branches.

In addition to the less stringent entry requirements for Australian banks to operate in China, a RMB clearing bank has been established in Sydney. The Bank of China, Sydney branch, will act as a RMB clearing bank, providing a more direct means of facilitating cross-border RMB transactions between Australian and Chinese entities and is expected to lower the cost of doing business in China for Australian entities. The clearing bank is expected to provide a competitive advantage for Australian businesses over their US rivals, and put them on a level playing field with China's other major Asian trading partners where clearing banks are located such as Singapore, South Korea and Taiwan.

Chinese Investment in Australia

The benefits for financial service providers flowing from the ChAFTA are not just one-sided. Significant changes have been made to the Foreign Investment Review Board (**FIRB**) screening thresholds for private Chinese investment in Australia. Chinese foreign investment in sectors such as telecommunications, transport and media is now subject to a higher FIRB screening threshold. Notably, commercial real estate – which formed 46% of Chinese direct investment in Australia in 2014[2] – also experienced a significant change, with the FIRB investment threshold for developed non-residential commercial real estate increasing to AU$1,094 million. In conjunction with changes made to the Significant Investor Visa rules, opportunities will arise for fund managers and other financial service providers to capitalise on the expected increase of Chinese investment in Australia.

Further Information

Please contact Michelle Segaert (Partner, Corporate), Amma Owusu (Associate, Corporate) or William He (Solicitor, Corporate) if you would like advice about any of the topics discussed in this article.

ASIC Updated Financial Reporting Relief Guidance for Registered Managed Investment Schemes

ASIC recently released the ASIC Corporations (Externally-Administered Bodies) Instrument 2015/251 (**Instrument**). Together with Regulatory Guide 174 (**RG 174**), ASIC has updated guidance for insolvent registered managed investment schemes (**MIS**) seeking relief from financial reporting obligations.

In this article, we summarise the eligibility criteria and reporting obligations for insolvent registered managed investment schemes.

2 See "Demystifying Chinese Investment in Australia May 2015", KPMG, May 2015

When is a Registered MIS Insolvent?

Technically, a MIS cannot become insolvent because an MIS is not an entity that incurs debts in its own right. The responsible entity is the entity that holds the MIS property and incurs debts to scheme creditors on behalf of the MIS.

A MIS may generally be described as insolvent when the MIS' property is insufficient to meet the MIS' liabilities to scheme creditors as they fall due, whether or not the responsible entity is itself insolvent or under some form of external administration.[3]

Relief Criteria

Not all insolvent MIS will be eligible for relief from financial reporting obligations. An insolvent MIS will only be eligible for relief if:

- a notice has been lodged by the responsible entity with ASIC notifying it that the winding up of the MIS has already commenced or a person has been appointed by the court to ensure that the scheme is wound up in accordance with the MIS' constitution; and
- the responsible entity or person appointed by the court has lodged a copy of a scheme insolvency resolution (passed by the responsible entity or other person appointed by the court) with ASIC that the property of the MIS has been insufficient to meet the scheme's debts for at least 12 months.[4]

ASIC's policy in giving relief is to remove the financial burden of compliance with financial reporting obligations by the MIS, which in such circumstances is otherwise borne by its members and creditors.

3 *Capelli v Shepard & Ors [2010] VSCA 2 at [93] and ASIC RG 174.97*
4 *Corporations (Externally-Administered Bodies) Instrument 2015/251 s7*

New Obligations

Where an insolvent MIS has obtained relief, new obligations will be imposed to ensure that members and creditors of the MIS are duly informed of any relevant developments. The Instrument requires the responsible entity or person appointed by the court to provide periodic reports to members and creditors. These reports must include:

- information about the progress and status of the winding up of the MIS;
- financial information about receipts and payments of the MIS; and
- the value of scheme property and any potential return to scheme members as at the end of the relevant reporting period.

The report must also be provided to the members and creditors no later than three months after the conclusion of the relevant reporting period, which is:

- for a report on the completion of a winding up that has taken less than 12 months to complete, the period commencing from the day the winding up commenced and ending on the day of completion of the winding up;
- for a report on the completion of a winding up that has taken longer than 12 months, the period commencing on the date after the end of the immediately preceding relevant period and ending on the day of the completion of the winding up; or
- otherwise, a period of 12 months.

The Instrument also requires the external administrator or responsible entity to have arrangements in place to answer any reasonable questions asked by a member of an externally administered MIS being wound up without charge.

Individual Application for Relief

ASIC may also grant individual deferral relief of some or all of the financial reporting obligations upon an application being made. Where ASIC has been formally notified of the commencement of the winding up of the MIS and in the reasonable opinion of the responsible entity or person appointed by the court the scheme is likely to be insolvent and ASIC is satisfied that compliance with the financial reporting obligations will impose unreasonable burdens, ASIC may defer some or all of the financial reporting obligations for a period of up to 24 months, and the compliance plan audit obligation for a period of up to 24 months.[5]

Individual deferral relief is only intended to apply where the MIS is or it is likely to be, insolvent.

ASIC will typically impose conditions of relief on the MIS if individual deferral relief is granted. Usual conditions include:

- notification of the deferral on a website;
- notifying the relevant market operator;
- notifying ASIC of any changed circumstances;
- ensuring adequate arrangements are in place to answer any reasonable questions asked by a member about the winding up; and
- a requirement to provide information about the progress and status of the winding up.

More Information

For further information regarding these new developments, please contact Michelle Segaert (Partner, Corporate), Amma Owusu (Associate, Corporate), or William He (Solicitor, Corporate).

Proposed Superannuation Governance Shake-up

On 26 June 2015, the Federal Government released exposure draft legislation to amend the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**). The key aspects of the exposure draft legislation are that all Australian Prudential Regulation Authority (**APRA**) regulated superannuation funds must have a minimum of one-third independent directors on their trustee board and an independent chairperson.

In this article we summarise these changes to the current superannuation governance framework and the proposed amendments to the SIS Act.

Value of Australia's Superannuation System

The Federal Government reports that the Australian superannuation system has more than AU$2 trillion in assets and based on the Federal Government's current projections, this figure is expected to grow to AU$9 trillion by 2040.[6] The Federal Government has justified the proposed governance changes as being critical for delivering benefits to superannuation fund members and for the effective management of the immense value of superannuation assets in Australia.

5 *Regulatory Guide 174,* para 174.25

6 *Media Release from the Honourable Josh Frydenberg MP, "Improving superannuation governance", 26 June 2015*

Current Superannuation Governance Framework

It has been a longstanding feature of the superannuation governance framework for industry funds, corporate funds and public sector funds (i.e. standard employer-sponsored funds) to have equal representation on their boards – that is, an equal number of employer representatives and member representatives and up to one independent director if provided for in the fund's constitution as permitted under the SIS Act (and more than one independent director is permitted if an application is made by the relevant fund to APRA). In the early days of the superannuation system, when many superannuation funds were corporate funds and smaller industry funds, equal representation was seen as an important policy objective to allow employees and employers to have equal oversight and responsibility for their funds. The Federal Government's view is that in today's superannuation system, where APRA regulated standard-employer sponsored regulated funds are mostly large industry and public sector funds, this policy objective has been superseded by the need for greater independence in governance of these fund's boards.

The Super System Review (also known as the Cooper Review)[7] back in 2010 examined the equal representation model and recommended to the then Labor Government that the SIS Act be amended to no longer require some superannuation trustee boards (in particular industry funds and public sector funds) to have equal representation in selecting their directors.[8] In addition, the Super System Review Panel noted that the incorporation and presence of independent directors on boards is best practice in corporate governance.[9]

The reforms have been strongly criticised by Industry Super Australia. Industry Super Australia's Chair Peter Collins has stated: "While industry super funds have always strongly supported best practice governance arrangements, with many boards evolving to appoint independent directors where required, we would caution against a "one size fits all" approach which would impose costly obligations on not-for-profit super funds in the absence of evidence to demonstrate the benefits to our members". There has been a mixed response from industry super fund executives with some calling it a political stunt and others confirming it will have little impact on them, since they already have a significant number of independent directors.[10]

7 *The Cooper Review delivered its final report on 30 June 2010*

8 *Explanatory Guide, Superannuation Legislation Amendment (Governance) Bill 2015, page 1*

9 *Explanatory Guide, Superannuation Legislation Amendment (Governance) Bill 2015, page 2*

10 *See for example: "Superannuation shake-up: Government's proposed rule changes a political stunt, industry fund executive says"*

Proposed Amendments

The Federal Government is proposing the following amendments to the SIS Act:

- Superannuation trustee board composition

  APRA regulated superannuation funds will be required to have a minimum of one-third independent directors on their trustee board and an independent chair. In the case of individual trustees, at least one-third of the trustees must be independent. The independent chair may be counted towards the minimum one-third independent director requirement. The appointment and removal of independent directors must comply with any relevant APRA prudential standards.

- Definition of Independent

  The definition of independent is to include persons who do not have a substantial holding in the superannuation trustee or do not have (or have not had within the last three years) a material relationship in the trustee including through their employer and have not in the last three years been an executive officer or director of a body that has a material relationship with the superannuation trustee board.

- Determination of Independence

  APRA may make a determination that a person is:

  - independent if APRA is reasonably satisfied that the person is likely to be able to exercise independent judgement in their role as a director; or
  - not independent if APRA is reasonably satisfied that the person is unlikely to be able to exercise independent judgement in their role as a director.

  APRA is able to make this determination on its own initiative or on application by the superannuation fund.

- Reporting: 'If Not, Why Not' Basis

  Registerable superannuation entity licensees acting as trustees of all APRA regulated superannuation funds must report on an 'if not, why not' basis, in their annual report as to whether they have a majority of independent directors commencing 1 July 2019.

Implementation

The Federal Government proposes a three year transition period to apply from the date of Royal Assent. However, where an APRA regulated super fund is established after 1 July 2016 it will have to adhere to the new governance measures from the time it is established.

Submissions

Interested parties are invited to comment on the exposure draft legislation by 27 July 2015.

More Information

For further information on regulatory issues affecting superannuation funds, please contact Michelle Segaert (Partner, Corporate) or Amma Owusu (Associate, Corporate).

FINTECH on the Rise

Although lagging behind the US and the UK, Australian financial technology (or FINTECH) businesses and companies are steadily gaining a profile and attention in the global arena – but you may ask what is FINTECH and what do I need to know about it?

FINTECH businesses are primarily software focused businesses, utilising new technologies and techniques to disrupt and improve the provision of financial services to consumers. In this article, we take a look at what is happening in FINTECH disruption in Australia.

FINTECH in Australia

Australia has a fertile technology start-up industry and a 2013 report by PriceWaterhouseCoopers '*The Startup Economy – How to Support Tech Startups and Accelerate Australian Innovation*', identified financial services as one of the leading industries targeted by startups. In early 2013, the Sydney FINTECH Startups Meetup was established by Pushstart; and in 2013-14, two notable venture capital funds focusing on FINTECH were established, namely Westpac's Reinventure and AWI Ventures.

Prior to these recent developments, the impact of FINTECH in Australia has predominantly been in technological developments offered by banks and financial institutions through internet and mobile banking applications.

However, the challenges faced by our major financial institutions with legacy infrastructure systems which are grappling with ever-changing regulation and fast-moving innovative technologies are providing significant opportunities for non-bank FINTECH businesses. There are also significant opportunities for non-bank businesses using FINTECH strategies to enter the financial services industry, where regulation permits.

Accelerating Change in the Industry

Despite increased investment in FINTECH in the last couple of years, Australia's banking industry is arguably not as innovative and technologically advanced as it otherwise might be. Australia still operates with an archaic payments system (with retail payments bilaterally cleared between financial institutions) and is currently working towards implementing a 'Fast Payments Solution' by 2017 (similar to the Faster Payments System introduced in the UK in 2008). Further, until very recently, Australian legislation has provided limited access for non-bank participants to operate within the payment systems and to conduct limited banking business, either as an APRA regulated provider of specialist credit card services (**SCCI**) or an APRA regulated provider of purchased payment facilities (**PPF**). To date, there have been few non-bank entrants, due to high barriers to entry, stringent regulatory requirements, legacy closed-shop payment systems, substantial costs of entry and the scale required to be competitive in the small Australian market. The most significant non-bank entrants to date have been Tyro (a payment gateway and competitor to the major Australian banks acting as a SCCI) and PayPal Australia (acting as a PPF). PayPal Australia now accounts for around 15% of all Australian online payments.[11]

Financial year 2014-15 has been described as a 'watershed' [12] year for FINTECH in Australia. This was highlighted by the KPMG report commissioned by the Committee for Sydney released in October 2014 entitled '*Unlocking the potential: The Fintech opportunity for Sydney*'.[13] The report included a key recommendation to establish a physical FINTECH hub in Sydney, and the release of the report coincided with the launch of two FINTECH co-working hubs in Sydney - a Government-backed not-for-profit hub called 'Stone & Chalk' and one privately funded hub backed by Tyro. The growth in the number of disruptive and viable FINTECH businesses in Australia in the last two years has been significant, offering new payments solutions, mobile payments and new financial products in competition with the major Australian banks, some of which are listed in the table below:

Online payments solutions	PayPal Australia, Paymate, POLi, Selz
Mobile payment solutions	Mint Wireless, Tyro, PayPal Australia (Braintree), Sniip Australia
Non-bank lending products	Nimble, DirectMoney, Bibby, Moula Money
Peer to peer lending products	Society One
Online financial advice – auto-mated advice	Stockspot, Movo, Financial Planning Online
Data analytics	Quantium, Contexti, Pocket-book
Customer experience	Tealeaf, Salesforce
Foreign exchange	OzForex, PepperstoneFx
Crowdfunding	Equitise
Increased non-bank credit cards and non-bank financial services (e.g., insurance, savings accounts, personal loans and home loans)	Virgin Money, GE Money, Coles[1] (using GE Capital Finance), Woolworths Money (using HSBC)
Virtual/ Crypto/ Peer to peer currencies	CoinJar, Bitcoin
Technology for trading	Metamako

Four such Australian businesses, Society One, Nimble, Metamako and Stockspot, have recently been listed in the top 50 global FINTECH companies.[14]

11 PayPal Australia has 5.5 million Australian consumers with accounts and 100,000 merchants with a payment systems relationship. The Australian, Damon Kitney, 4 April 2014

12 David Gilligan, one of the co-founders of Westpac's Reinventure Group, was quoted as making this statement, Australian Financial Review, 5 January 2015

13 "Unlocking the potential: The Fintech opportunity for Sydney", KPMG, October 2014

14 '50 Best Fintech Innovators' Global Report, KPMG, AWI Ventures and Financial Services Council (www.fintechinnovators.com)

What's Next?

The acceleration in innovation and technological advances in Internet businesses, data management and mobile payments is forcing the major banks in Australia to be at the forefront of new technologies to remain competitive. In the past two years, there has also been demonstrable investment by the major banks in new platform and mobile technologies.[15]

At the same time, our key regulators, the Reserve Bank of Australia, APRA and the Australian Securities & Investments Commission, have been focussed on updating Australian laws and regulations to comply with international standards (in particular, the CPSS- IOSCO Principles for financial market infrastructure).

In the future, we expect to see more partnering between major financial institutions and start-up FINTECH businesses to bring new technologies to market (such as being pioneered by Westpac's Re-Inventure Fund).

Having regard to the rapid rate in which FINTECH has been evolving in the past few years and following what has been happening in the UK and the US, combined with the recent changes to the SIV complying investment framework with a focus on venture capital, we expect that technological advances in the provision of financial services in Australia will accelerate at unprecedented rates. As stated by Peter Nash, Chairman of KPMG in relation to the management of KPMG Capital, a US$100 million fund focused on investing in big data analytics launched in November 2013, "an urgent need for new digital tools is being created as firms face a choice between either being disrupted or disrupting themselves and their rivals with new channels to market".[16]

Further Information

Squire Patton Boggs were heavily involved in the writing of "Understanding FINTECH and Banking Law: A Practical Guide". Lawyers from Washington DC, Leeds, Frankfurt, Tokyo and Sydney contributed to the book and this illustrates our global approach to corporate finance. Michelle Segaert (Partner, Corporate) and Amma Owusu (Associate, Corporate) contributed to the drafting of the Australian chapter and update of the book. If you would like more information about how regulatory issues facing Australia's FINTECH industry may impact your business please contact Michelle or Amma.

15 See 'Fintech disrupts Financial Services' 4 December 2014, www.mcgrathnicol.com/fintech

16 Peter Nash, chairman for KPMG Australia was quoted as making this statement, Australian Financial Review, 7 July 2015

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