

31 August 2021

Treasury
Langton Cres
Parkes ACT 2600
Email: superannuation@treasury.gov.au

Dear Treasury

Re: Corporations Amendment (Portfolio Holdings Disclosure) Regulations 2021

Industry Super Australia (ISA) is a research and advocacy body for Industry Super Funds. ISA manages collective projects on behalf of 13 industry super funds with the objective of maximising the retirement savings of nearly five million industry super members.

ISA supports increasing the transparency of assets held by superannuation funds to be provided through Portfolio Holdings Disclosure (PHD). However, as set out in our submission¹ on the previous draft regulations released in April 2021, it is important that members' interests are not adversely affected in pursuit of transparency.

The proposed regulations, which will require unprecedented granular disclosure of price sensitive assets managed directly by superannuation funds, will in their current form have several serious adverse consequences for members including:

- ▶ Diminishing realised returns on the eventual sale of unlisted assets by reducing the premium paid above the carrying value of the asset
- ▶ Reducing the likelihood funds will internalise investment management of price sensitive asset classes resulting in higher investment management costs for members
- ▶ Reducing competitive pressure on external fund managers to reduce fees on price sensitive asset classes by undermining competing internal investment models

Taken together these consequences suggest the proposed disclosures are not sector neutral with not-for-profit funds (which have used scale to benefit members through unlisted asset ownership and increasingly internal investment models) being disadvantaged relative to other market participants that utilise conventional intermediated investment models and non-superannuation institutional investors.

Furthermore, this submission argues the proposed commercially sensitive disclosures are not warranted to ensure the timely and proper valuation of unlisted assets with ASIC recently finding high standards are prevalent and operating in the interests of members. Finally, the proposed regulations also seem at complete odds with new Government

¹ <https://www.industrysuper.com/assets/FileDownloadCTA/ISA-submission-on-draft-YFYS-regulations.pdf>

legislation² exempting the Government run Future Fund from FOI requests on commercially sensitive investments.

ISA recommendation: The government must protect members' interests and consider the risks associated with funds disclosing the individual values for unlisted assets. The government should:

- ▶ Allow each unlisted asset to be separately identified but provide only an aggregated value for the group, or
- ▶ Allow the value for each unlisted asset to be disclosed as a range instead of a dollar value.

Disclosure of valuations will reduce sale premia

Unlisted assets such as infrastructure, real property and private equity are more sensitive to disclosure of their market value. Providing a value for each unlisted asset informs the market of a potential sale price for that asset and consequently limits the price that can be achieved because buyers will anchor to the disclosed price.

The effect is to limit the potential upside and in doing so, reduce the financial return for members.

Indeed, this was a finding of the NSW Auditor general when reviewing the State Government's partial sale of Ausgrid in 2016 noting price disclosure (akin to a valuation) likely diminished the outcome achieved for taxpayers:

"However, an acceptable price was revealed early in the negotiation process, and doing so made it highly unlikely that the proponent would offer a higher price than that disclosed."³

The NSW Auditor general's findings are not hypothetical. Completed transactions demonstrate significant value has been generated for members where the sale of unlisted assets (with undisclosed valuations) have significantly exceeded the carrying value of the asset.⁴

This issue has been raised by industry funds with Treasury on numerous occasions and ignored even though an appropriate regulation making power to address this issue exists.⁵ Feedback to the previous draft regulations from a number of organisations again raised this issue. However, instead of listening to the feedback, the revised draft regulations require even more granular disclosure. Trustees will now be required to disclose the percentage ownership interest that the fund has in a property or infrastructure asset.

In the same way that individuals will never disclose the reserve price of their house before they take it to auction, the proposed legislation risks harming members' financial interests by disclosing the reserve price of unlisted assets.

² Investment Funds Legislation Amendment Bill 2021

³ Audit Office of NSW, Report 11 December 2018 (page 1)

⁴ For example the sale of Pacific Hydro in 2016 for \$2.3 billion was 2.75 times carrying value

⁵ See Corporations Act s 1017BB(1A)

Unlevel regulatory playing field will discourage investment fee reductions

The junking of full look through

The original PHD requirements legislated by the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012 required disclosure of portfolio holdings on a 'full look through' basis but also allowed for non-disclosure of up to 5% of assets including those whose value was commercially sensitive⁶.

The full look through reporting ensured there was a level playing field which meant members would benefit from disclosure about the underlying investments in a fund irrespective of investment structure involved.

These requirements were subsequently amended⁷ to remove the obligation to include PHD information in respect to financial products or other property that non-associated entities have invested in or reporting obligations on parties to contracts that acquire a financial product using the assets or assets derived from assets of an RSE.

Put simply PHD was amended to reduce disclosure obligations on assets which are more financially intermediated rather than directly held by the reporting entity. No rationale was advanced then or now as to why members should know less about investments that are more financially intermediated and opaque.

Along with the proposed regulations consulted on here this has implications for the way in which superannuation funds invest now and into the future where the underlying asset's price is commercially sensitive.

Preventing downward pressure on investment fees

Assets which involve higher levels of financial intermediation by non-associated investment managers typically involve higher costs and lower returns for superannuation fund members with more parties clipping the ticket between the underlying asset and the member. Typically, this involves the payment of ad valorem fees. If a fund has sufficient scale it may consider internalising investment management on certain asset classes where investment management costs can be fixed allowing for the marginal cost of investment to fall.

For example, CBUS Super has reduced total portfolio investment management costs by more than one third from 86bps to 56 bps through internalising investment management. This saved members \$135 million in 2019-20 and \$240million since 2017-18⁸. Depending on scale and the asset class in question investment costs to members can be more than halved.

⁶ Now repealed S 1107BB(5A)

⁷ See Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2019

⁸ CBUS annual report June 2020

Private equity is a highly price sensitive asset class which large funds may seek to internalise in the future. Existing investment management costs can be in excess of 250bps however the proposed regulations would make such a move prohibitive as the realised returns on eventual sale would be slashed due to disclosure of carrying values over time on each private investment when no such disclosure would be required for private equity investments made through a specialist non-associated manager.

As a consequence, members would not benefit from fee reductions, and the revenues of non-associated investment managers would be shielded from an important new source of competition further acting to reduce downward pressure on fees. Such a regulatory outcome is foreseeable and is effectively a protection racket for the funds management industry. It is not in members interests.

This is supported by international evidence in the US where CalPERS recently abandoned its in-house private debt program after regulatory disclosures made it untenable⁹.

Double standard for Government's own Future Fund

It would appear the Government is fully aware of the impact of the disclosure of commercially sensitive information on fund investments. The Future Fund currently does not disclose the valuation of individual unlisted assets which it holds, although the valuations are fully audited.

The Government has moved further to protect commercially sensitive investment information including valuations with the introduction of the Investment Funds Legislation Amendment Bill 2021 to exempt the entity from FOI disclosure of such information. The explanatory material for the Bill indicates the full disclosure of commercially sensitive investment information may impact on the successful execution of the investment strategy of the fund. It is unclear why the Government has decided to propose regulations that will undermine the investment strategies used by superannuation funds that steward the retirement savings of millions of Australians.

No evidence that regulatory intervention is needed

ASIC review of illiquid asset valuation practices

In August 2021 ASIC released the findings of its review of managed funds' valuation of illiquid assets.¹⁰ The review examined how well the responsible entities managed illiquid asset valuation whilst meeting their regulatory obligations during a period of heightened market volatility. The review covered direct real property, mortgage, infrastructure, private equity, private debt and hedge funds.

ASIC found the illiquid-asset valuation practices "to be robust, timely and consistent with ASIC guidance and industry standards" and accordingly saw no need to change its guidance on valuations for managed funds.

⁹ See: [CalPERS' In-House Private Debt Program Is Dead \(ai-cio.com\)](https://www.aic.gov.au/news-centre/find-a-media-release/2021-releases/21-212mr-asic-finds-good-practices-from-covid-19-review-of-managed-funds-valuation-of-illiquid-assets/)

¹⁰ <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2021-releases/21-212mr-asic-finds-good-practices-from-covid-19-review-of-managed-funds-valuation-of-illiquid-assets/>

This review demonstrates that valuation practices are appropriate, undertaken at a high standard and that no further regulatory intervention is warranted.

Findings of Royal Commission

Evidence given to the Royal Commission by Australian Super in relation to its investment on Pacific Hydro¹¹ again highlights that with appropriate and robust governance, no regulatory intervention is needed. It also demonstrates the risks to members' returns of the disclosure of valuations of infrastructure assets.

- ▶ In 2011, Australian Super was concerned about the performance of its investment in Pacific Hydro and became more heavily engaged with the fund manager on its performance.
- ▶ In 2014, Pacific Hydro's performance deteriorated and its performance was written down significantly. A strategic review was initiated and corrective action taken.
- ▶ In 2016, the fund manager sold Pacific Hydro, generating returns significantly higher than its valuation before the write downs in 2014.

If Australian Super had been required to disclose the value of its investment in Pacific Hydro in 2014, it would not have achieved a return that was significantly higher than the 2014 valuation.

Commissioner Hayne noted:

Not all investments will perform well. Nor can a superannuation trustee guarantee the performance of investments. However, the trustee does promise its members that it will act in their best interests and exercise the same degree of care, skill and diligence as a prudent trustee. These are not impossible standards to satisfy even when an investment's performance is less than is desired. Australian Super's monitoring and management of its indirect investment in Pacific Hydro illustrates that this is so.¹²

ISA Recommendation

ISA proposes two options for disclosing of the value of unlisted assets in ways that will protect the interests of members:

- ▶ Allow each unlisted asset to be separately identified but provide only an aggregated value for the group, or
- ▶ Allow the value for each unlisted asset to be disclosed as a range instead of a single dollar value.

Both options provide disclosure to members and the market about the specific assets in which the fund is invested with either an aggregate value for the group or a range for individual assets. In doing so they provide transparency of the holding without limiting the sale price of unlisted individual assets.

¹¹ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 2, p 238-240

¹² Royal Commission Report, p 248

Finally, we expect that some funds may find compliance with the detailed disclosure requirements challenging in the time frame proposed and may need to seek relief from ASIC.

If you would like to discuss this submission, please contact Ella Cebon at ecebon@industriysuper.com.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ella Cebon', with a long horizontal flourish extending to the right.

Ella Cebon
Senior Policy Adviser