Financial System Inquiry Interim Report

Second Round Submission
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About Morningstar

Morningstar Australasia Pty Limited is a subsidiary of Morningstar, Inc., a leading provider of independent investment research in North America, Europe, Australasia, and Asia. The company offers an extensive line of products and services for individual investors, financial advisers, asset managers, and retirement plan providers and sponsors. Morningstar provides data on approximately 473,000 investment offerings, including stocks, mutual funds, and similar vehicles, along with real-time global market data on more than 12 million equities, indexes, futures, options, commodities, and precious metals, in addition to foreign exchange and Treasury markets. Morningstar also offers investment management services through its registered investment adviser subsidiaries and had approximately US$169.0 billion in assets under advisement and management at 30 June 2014. The company has operations in 27 countries.

Summary

In this submission Morningstar has responded to three areas from the Financial System Inquiry Initial report:

- Consumer Outcomes: Effective Disclosure;
- Funding: The Corporate Bond Market; and
- International Integration.

As a global provider of independent investment research with operations in 27 countries, it's clear to us that the adoption of international regulatory best practice can reduce industry costs, simplify messages to the fund industry, and lead to better disclosure practices. Global consistency can increase efficiency in the formulation of policy and drives scale benefits to the implementation of everything from disclosure to investment management.

Disclosure requirements need to be framed having regard for both professional intermediaries, in addition to the investors they serve. To do otherwise ignores the broader ecosystem that can be constructed around disclosure. Better minimum standards for ongoing disclosure are as important as point of sale measures in increasing investor protection and literacy. Layered, electronic disclosure can generate better disclosure with reduced incremental costs while also increasing consistency of disclosure between different security types.

A deeper and more liquid retail corporate bond market will increase the range of available funding options to domestic borrowers and help increase capital allocation of Australian investors to this market. A reduction in supply side costs is the most important step in the development of this market, but must be done in a way that continues to offer some safeguards for potential investors. The S&P/ASX200 provides a deep and highly transparent pool of potential issuers and it is these issuers that we believe should be afforded simplified offer documents for vanilla bonds.

Funding: The Corporate Bond Market (2-86)

FSI Observation

Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.

Summary

- A deeper and more liquid retail corporate bond market is a positive step in addressing the under-allocation to the fixed income asset class in Australia;
- A deeper and more liquid retail corporate bond market provides a platform to promote education of the fixed income asset class and its role in a diversified portfolio; and
- A deeper and more liquid retail corporate bond market will increase the range of available funding options to domestic borrowers.

Comment

Consistent with Morningstar's mission of creating great products that help investors reach their financial goals, we support initiatives to develop a deep and liquid retail corporate bond market. We believe adding breadth and depth to the retail corporate bond market in Australia would provide retail investor clients with more investment options and provide diversification benefits to their investment portfolios.

We believe that increasing the available range of investible retail corporate bonds will encourage greater retail investor awareness of fixed income. Increased awareness in combination with improved access should establish the platform for higher retail investor exposure and more suitable asset allocations relative to their risk profiles and time horizons.

FSI Question

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives: *Allow listed issuers (already subject to continuous disclosure requirements) to issue 'vanilla' bonds directly to retail investors without the need for a prospectus.*

Summary

- Morningstar supports less onerous prospectus requirements for listed issuers;
- Morningstar proposes restricting eligible 'vanilla bond' issuers to S&P/ ASX200 index constituents;
- Morningstar supports removing restrictions on the term of retail corporate bond issuance; and
- Morningstar supports increasing the range of eligible securities that can be issued to include subordinated debt, noting that these would be pure debt securities.

Comment

(i) Without compromising retail client safeguards, simplifying the issuance process for listed issuers would be beneficial to issuers and the investment community. With the proviso that an issuer complies with required continuous disclosure practices, we support removing the need for a prospectus when issuing a simple corporate bond. We believe that disclosure costs for issuers should not be materially different between retail issues and other forms of debt and equity financing.

We recommend a simple offering document on issuance in the form of a two page term sheet plus a supporting Information Booklet, approximately ten pages, that allows for information to be incorporated by reference. These should be in the form of standardised templates and written in 'plain English'.

The term sheet would outline the specifics of the security being issued (refer Appendix 1). The Information Booklet would be a more evergreen document containing details about the issuer, security and risks (refer Appendix 2). These would be minimum requirements but there should be an option for the issuer to provide information beyond the required minimum if desired. To make this offering as efficient as possible, we do not believe the offering documentation needs to include factual information that is made public on a continuous or periodic basis by the issuer. This includes, but is not limited to financial statements.

(ii) Morningstar proposes restricting eligible issuers to S&P/ASX200 index constituents for the following reasons.

a. To prevent smaller market capitalised listed companies issuing above their means to the point that they become a high risk investment which is then sold on to clients as a low risk security by virtue of it qualifying as a 'simple corporate bond'. We do not want the scenario whereby a AUD 50 million market capitalised company issues a AUD 50 million bond, which is then sold to low risk clients under the guise of a low risk investment by virtue of it qualifying as a 'simple corporate bond'.

b. In allowing 'vanilla' bonds to be issued to retail investors, the level of research coverage should be considered in addition to the disclosure requirements already met by listed issuers. Where the listed equity of an issuer is subject to research, a third party is already distilling the various announcements from a company into a view on that entity and the entity has already been subject to increased scrutiny. The S&P/ASX200 is characterised by breadth and depth of public information and analyst coverage. By way of example, Morningstar's credit and equity analysts, who work alongside one another, currently provide independent analysis on most S&P/ASX200 companies.

Should an S&P/ASX200 constituent want to issue into the retail bond market, the fact that Morningstar already provides coverage on that company reassures us that a simple offering document will suffice when it comes to assessing the merits of that investment.

c. Experience in overseas retail bond markets, such as the U.K., has shown us that retail clients tend to display a familiarity bias, whereby they are more comfortable buying a brand name rather than a name they are not familiar with. The vast majority of listed recognisable brand names are included in the S&P/ASX200.

d. It provides a safeguard that gives us confidence when suggesting expanding the terms of 'vanilla bonds' as proposed in suggestions (iii) and (iv) below.

(iii) Removing the requirement for a maximum term of maturity, currently proposed at 15 years (Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014 (713A (6))). We believe the maturity of the issue should be a function of client demand. The ability to increase maturity over a longer range can only act as a further incentive to issue as well as suit retail clients with longer-term investment time horizons. We appreciate the concern that default risk increases with duration, however, we would expect this risk to be outlined in the issuing documentation and subsequently assessed against the investment profile of the client.

(iv) Increasing the range of eligible securities along the capital structure that can be issued to include subordinated debt, noting that these would be pure debt securities (Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014 (713A (14))). We support widening the investible range of securities to retail investors across the entire capital structure. We anticipate this will act to support issuance on the supply side.

We see the proposed legislation as a positive step towards building a deep and liquid retail bond market. However, we believe that a staggered approach is best with regards to criteria, allowing for widening down the track as the retail bond market develops. Driven by an under-allocation to fixed income, the domestic retail investor market has a long way to go when it comes to being educated about the fundamental characteristics of fixed income. This underlies why we believe a disciplined approach such as restricting issuers to the S&P/ASX200 provides a stable safeguard while the education process rolls out.

We look forward to taking an active role in educating the retail market about investing in fixed income. Similarly, we look forward to working with the relevant regulatory authorities to help strike the right balance between all interested parties.

Appendix 1: Sample Term Sheet

Issuer:	Example Co. Ltd.
Instrument:	Corporate Bond
Currency:	AUD
Ranking:	Senior Unsecured
Guarantors:	None
Repayment:	Full repayment of principal at maturity
Issue Price:	AUD 100
Denominations:	AUD 100
Coupon Type (Fixed/Floating):	Floating
Coupon Formula:	Issue margin plus the reference rate
Issue Margin:	5.0%
Reference Rate:	90 day bank bill swap rate (BBSW)
Coupon Payable (BBSW + Issue Margin)	7.5% (2.5% + 5.0%)
Coupon Frequency:	Semi-Annual
Coupon Payment Dates:	31 January and 31 July each year
Announcement Date:	14 January 2015
Offer Period:	14-27 January 2015 (5pm or earlier)
Settlement Date:	31 January 2015
First Day of ASX Trading:	31 January 2015
Maturity/Term of the bonds:	31 January 2025 / 10 years
ISIN Number:	AU123456789
Issue Size:	Subject to demand, target is AUD 50m
Minimum Subscription:	AUD 1,000
Covenants:	None
Key financial ratios pre-issue:	Gearing/Interest Coverage
Key financial ratios post-issue:	Gearing/Interest Coverage
ASX Code:	EXAMP
Listing:	Australian Stock Exchange, ASX
Lead Manager:	ABC Bank

Appendix 2: Sample Information Booklet Criteria

The Information Booklet would be a more evergreen document containing details about the issuer, security and risks. It should be in the form of standardised templates and written in 'plain English'. As a minimum it should contain the following content:

- A 'Bond Basics' page. This will include:
- a general definition of a bond;
- a diagram displaying where the bonds being issued sit on the capital structure of the issuer;
- what dollar value interest payment will be paid on the face value of the bonds; and
- when the principal payment will be redeemed.

It should also include an overview of the issuer. This will include an overview of the company and its strategy:

- A description of the security;
- Key features of the bonds (as per the Term Sheet);
- Key risks of investing in the bonds;
- Issuers' and securityholders' rights;
- An 'Other Information' section. This will include, but need not be limited to, details such as taxation implications, how to trade the bonds and associated fees; and
- A 'Queries' section. This will include where other information on the bonds and issuer can be obtained (including by a website link), who to contact with queries regarding the bonds and an outline of the complaints process.

Consumer Outcomes: Effective Disclosure (3-54)

FSI Observation

The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.

Summary

Morningstar supports:

- a review of the current disclosure regime;
- increased consideration of the needs of professional intermediaries in determining, and assessing the effectiveness of, disclosure requirements;
- limiting requirements on point of sale disclosure documents to key product features;
- additional requirements for the ongoing disclosure of key information;
- increasing use of electronic disclosure;
- increasing use of layered disclosure;
- adoption of international standards where practicable to reduce the costs of disclosure; and
- the Australian Securities & Investments Commission having additional product intervention and product-banning powers, provided sufficient resources are allocated to implement these powers effectively and consistently.

Morningstar does not believe that subjecting product issuers to product design requirements is a priority at this stage, and believes that more effective disclosure is a better path to improving outcomes for investors.

Comment

Discussion around disclosure requirements for collective investment schemes, including managed funds and superannuation funds, has been defined too narrowly to what is required by the average investor at the point of sale. While these are clearly important considerations, they do not reflect the additional consumer benefits that can stem from the disclosure used by intermediaries who serve the needs of investors, and the insights that can be gathered from ongoing disclosure.

The continuous disclosure requirements for listed Australian shares are a good example of the eco-system that can be constructed around disclosure. This is an eco-system far broader than the direct relationship between an investor and the issuing company, but also encapsulates a large pool of research analysts, numerous information sites, intermediaries, and the media. An investor will not have read every announcement to the ASX, but will benefit from the large numbers of people reviewing these documents and surfacing the important points through various mediums. This disclosure, and the scrutiny that comes with it, underpins the efficacy of

this market and helps inform potential investors. Indeed, it is this range of intermediaries that quite often provide the plain language explanations sought after by regulation. Some of these principles and learnings should be applied to the world of collective investments.

Morningstar's Global Fund Investor Experience Report 2013 (https://corporate.morningstar.com/us/documents/MethodologyDocuments/FactSheets/Global-Fund-Investor-Experience-Report-2013.pdf), which assesses managed fund investor experiences in 24 countries across North America, Europe, Asia, and Africa, scored Australia C+ overall, but in Disclosure the score was D+, falling behind 20 other countries.

Australia is the last country in the survey without any form of mandated, periodic portfolio holdings disclosure. With mandatory quarterly disclosure global best practice, Australia is very far from the mark. There are positive steps underway, however, with voluntary disclosure standards well-advanced and a mandated requirement in the MySuper regulations.

Australia's product disclosure statement also misses some marks as a simplified prospectus. Nowhere in the disclosure is portfolio manager information available. The document also lacks standardised returns, and often poorly describes investment strategy and risks.

At a minimum, offer documents should provide plain language explanations of what the investment is; what are the risks, possible returns, how much it costs, who is managing the money and whether they invest in the fund they are managing. Information that should be available on a layered, electronic basis and updated with material changes should include:

- Portfolio Manager(s) and date appointed;
- Investment philosophy and process;
- Organisational structure/ownership;
- Annual Audited Financial Statements;
- Annual Reports – including detailed commentary on performance against objectives;
- Periodic Portfolio Holdings; and
- Details of the directors of the responsible entity.

The difficulty for an investor in identifying individuals responsible for bringing a product to market and those managing it is a material weakness in the current disclosure regime and is in stark contrast to the requirements for listed equities and global best practice for funds.

The Inquiry has raised the potential for more default products or the regulation of product features. Morningstar does not believe these steps are a priority at this juncture. Better disclosure practices will facilitate increased competition and lead to improved product features.

Subject to adequate resourcing, we believe additional product intervention and product-banning powers for ASIC would be appropriate. Specifically, reducing the time period between ASIC first becoming aware of an issue and subsequent action would be an important improvement.

Financial literacy is an important and multidimensional topic. One important component of literacy is engagement. Our US experience is that stronger disclosure has enabled the creation of better research, tools and media commentary which, in turn, has led to higher levels of investor engagement and literacy.

International Integration (4-73)

FSI Observation

Although elements of Australia's financial system are internationally integrated, a number of potential impediments have been identified. Financial system developments in the region will require continuing Government engagement to facilitate integration with Asia.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives: *Improve domestic regulatory process to better consider international standards and foreign regulation — including processes for transparency and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.*

Summary

- From the perspective of fund investors, adoption of international regulatory best practice can reduce industry costs, simplify messages to the fund industry, and lead to better disclosure practices.
- While participation in mutual recognition schemes offers export opportunities for the financial services sector and increased options and diversity than would otherwise likely exist for end investors, from global experience, there is no evidence that costs to end investors would decrease.

Comment

Morningstar publishes a biennial Global Fund Investor Experience study which aims to encourage dialogue about global best practices for mutual funds (managed funds) from the perspective of fund investors across 24 countries. The study includes consideration of international regulatory standards related to managed funds, including the structure and effectiveness of regulatory bodies.

In Morningstar's view, from the perspective of fund investors, the best regulatory practice is to have a single regulator independent of the funds industry, overseeing all investment funds. Having a single rather than multiple regulators and having this single regulator oversee all investment funds helps reduce the cost of regulation and simplifies the message to fund companies. This is not the case in Australia, with multiple regulators (ASIC and the Australian Prudential Regulation Authority) for the funds industry and the Australian Tax Office regulating self-managed superannuation fund compliance.

Regulatory global best practice also includes adequate staffing, stability and public disclosure. Public disclosure of the regulator's actions serves two purposes. First, it discourages malfeasance by deterring similar violations. Second, it gives the investing public the confidence that it is aware of all industry issues – nothing is being hidden from view. Most countries

struggle to update their regulations to address new portfolio management techniques. In Australia, while regulations are regularly updated, they are often delayed and sometimes fail to address known problems, such as poor disclosure practices by asset managers (as assessed by global best practices).

The costs and benefits from participating in mutual recognition schemes and equivalence assessment processes can be evaluated through the experience of the Undertakings for Collective Investments in Transferable Securities directive (UCITS) scheme and the Markets in Financial Instruments Directive (MiFID) in Europe. These frameworks ensure that fund regulations, disclosures and marketing practices meet minimum standards across Europe. As a 'fund passport' scheme, UCITS makes cross-border financial product distribution more efficient, leading to increased investment options for investors and allowing more diversity than would otherwise exist for investors in their own relatively small home markets.

There are three funds passport initiatives developing in the Asia-Pacific region that provide mutual recognition and equivalence assessment processes in the distribution of managed funds. Australia is a key participant in one of these initiatives, the Asia Region Funds Passport scheme, which also includes New Zealand, the Philippines, Singapore, South Korea, and Thailand. There are potentially material benefits from Australia's participation in this scheme, through the potential export of financial services, building on our expertise in funds management as well as back-office operations such as administration and custodial functions as well as legal, compliance and accounting support.

With regard to limitations in adopting 'international standards and foreign regulation', although fund investors do benefit from greater choice and diversity through fund passport schemes, it is unclear whether these schemes necessarily lead to lower fees for end investors, which is usually flagged as a potential benefit. While the UCITS framework promotes consistency and provides synergies for participants, there is no evidence that it leads directly to cost savings for managed fund investors. It is in fact 'closed' countries such as the US and Australia that have on average lower fees than UCITS markets. If we take Hong Kong's experience as a cross-border market as an example, despite a smaller 'target' market, funds domiciled in Hong Kong have proved overwhelmingly cheaper than their Ireland or Luxembourg domiciled UCITS peers.

Supporting details are contained in the Fee section of Morningstar's Global Fund Investor Experience Report 2013:
https://corporate.morningstar.com/us/documents/MethodologyDocuments/FactSheets/Global-Fund-Investor-Experience-Report-2013.pdf.