File Name: 2014/20

14 May 2014

Australian Taxation Office
GPO Box 9977
Adelaide SA 5001

Attention: Mr. Andrew Fort

Email: andrew.fort@ato.gov.au

Dear Andrew,

RE: Draft Taxation Ruling TR 2014/D2

As advised by email on 12 May, the Association of Superannuation Funds of Australia (ASFA) would appreciate consideration being given to this supplement to our submission of 2 May on *Draft Taxation Ruling TR 2014/D2 – Income tax: the application of the foreign income tax offset limit under section 770-75 of the Income Tax Assessment Act 1997 to foreign currency hedging transactions* ("the Draft Ruling").

The purpose of this supplementary submission is to provide further support for our earlier submission and in particular to illustrate the complexity involved in the trading of foreign currencies.

About ASFA
ASFA is a non-profit, non-politically aligned national organisation. We are the peak policy and research body for the superannuation sector. Our mandate is to develop and advocate policy in the best long-term interest of fund members. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

Supplementary comments
Source of the gain
As stated in our submission of 2 May 2014, the Draft Ruling appears to conclude that the source of any gain is where the contract which effects the trade is formed (paragraph 102) and that the actual source seems to be where the counterparty agrees to the terms of the individual transactions (paragraphs 100 - 101). We note that Example 1 is somewhat imprecise as to how to determine exactly where the counterparty agrees to the terms of an individual trade. In that example, the foreign desk of the hedge manager places an order with a foreign counterparty and it is then assumed that the contract is "formed" overseas without detailing any specifics.

On our reading, it seems the Draft Ruling concludes that the formation of the contract is not determined by where (or by whom) the order is placed (refer discussion in paragraphs 148 – 150) but rather where such offer is accepted by the counterparty.

As set out in our submission, we consider that the analysis in the Draft Ruling is too simplistic. It only contemplates a single contractual transaction between two entities. This understates the complexity of hedge trading and in particular:

- the need to access markets in different time zones
- the methods used by large hedge managers when they access those markets on behalf of a stable of clients

- that trading is done in many instances on the phone
- that trading is done through trading platform servers, the location of which is not revealed
- the fact that the counterparty does not reveal its location as it is contracting as an entity, not as an office
- that when algorithms are used, the trade may be made on behalf of a number of clients, where parameters are set with an entity which then allows other counterparties to conclude the trade, and
- that trades are usually not notified of acceptance but rather are accepted by not being rejected.

ASFA considers that any attempt to isolate and identify such an acceptance is nearly impossible in the context of the hedging activities undertaken by fund managers. Being required to do so for the purposes of determining the source of the contract could potentially:

- impose a significant compliance burden on both hedge managers and super fund managers
- lead to manipulation so as to have the gain or loss sourced domestically
- create an un-level playing field between overseas and domestic hedge managers which would result in the Australian fund managers being denied access to the larger fund managers operating in the overseas markets, and
- create tax risks due to the potential to misidentify the 'correct' contract formation point.

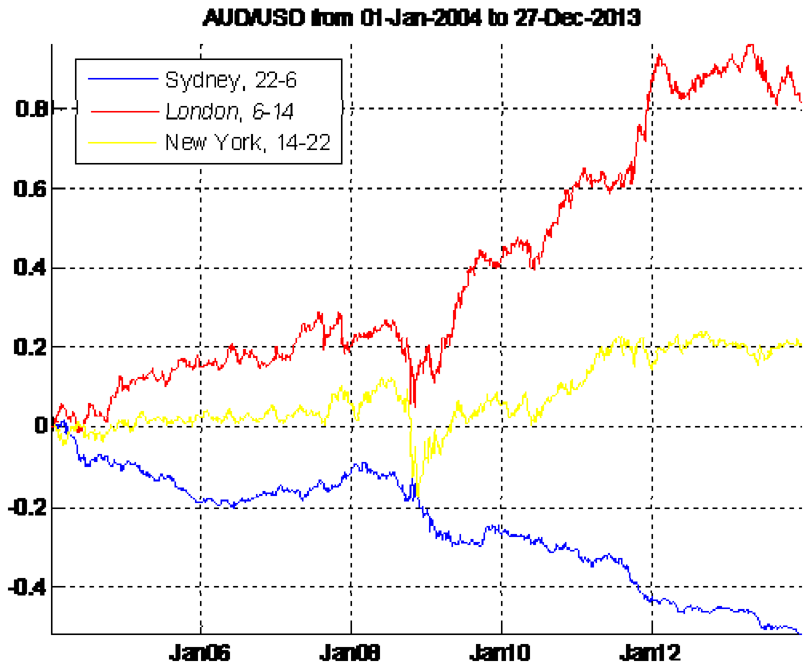
Overall, ASFA considers that the most appropriate method of determining source would be to have reference to where the ISDA and the IMA are formed. This would resolve the complexity involved in needing to determine where each individual trade is concluded and would allow super funds to access different markets and managers without making decisions based on the manner and how the relevant manager carries out its trades, which is commercially irrelevant.

The following information on how these markets operate is provided so that an appreciation can be gained of the difficulty that would be faced by taxpayers in applying the principles of the Draft Ruling.

Market risk - currency movements outside of Australian hours

A significant portion of moves in exchange rates against the Australian dollar can and does occur overnight. Should the outcome of the draft ruling result in taxpayers restricting trading to Australian banks in the Australian time zone it will potentially leave large spot changes unmanaged. From the point of view of risk management and hedging this would represent a significant increase in risk to Australian superannuation funds. Unfavourable exchange rate fluctuations could be significant. The Figure on the following page shows the cumulative spot changes in each of the three major time zones. The Figure clearly shows the persistent difference between London and Sydney trading.

Figure - Market Risk



Source: Thompson Reuters'

Liquidity Principle
As a general principle, Australian investors should have access to foreign exchange liquidity when it is needed and available to implement currency hedges. This is particularly true of the Australian superannuation market due to its large size and high level of offshore investment.

In a recent Bank for International Settlements (BIS) article entitled *"The anatomy of the global FX market through the lens of the 2013 Triennial Survey"* by Dagfinn Rime and Andreas Schrimpf, the following three key points are made:

1. The trading of firms such as institutional investors and hedge funds is concentrated in a few locations, in particular London and New York, where major dealers have their main FX desks. With a share of over 60% of global turnover, these locations are the centre of gravity of the market.
2. Investors seeking best trade execution often prefer to trade via sales and trading desks in London or New York (even though these investors may have their head office in other time zones). This is because liquidity in currency markets is typically highest at the London open and in the overlapping hours of London and New York.
3. The rise in electronic and algorithmic trading also contributed significantly to the concentration in centres. For certain types of algorithmic trading, speed advantages at the millisecond level are critical. Such high frequency trading requires co-location close to the servers of electronic trading platforms, typically in the vicinity of London and in New Jersey.

Conclusion
The Foreign Exchange market continues to be concentrated in a few locations allowing a wide range of market participants to access the greatest liquidity and to ensure that risk management strategies are executed in the most efficient manner. An ATO policy position that encouraged taxpayers to self-impose a restriction on this access would inevitably lead to sub-optimal outcomes.

As noted in our earlier submission, even if there were a 24 hour Australian trading desk and the costs and efficiency issues could be managed, there would still be the risk that the gains are not Australian sourced due to the ATO proposed position that reference has to be made to where the individual trade is actually accepted. As stated in that submission, ASFA considers that there is a real risk that there is an insufficient number of Australian counterparties to meet the needs of the Australian superannuation industry (especially as the funds under management within the industry grow to be larger than the Australian GDP).

ASFA requests that any position taken by the ATO that would effectively serve to restrict the access of the superannuation funds to these foreign managers by virtue of what we believe to be an inappropriate application of the source rule should be avoided.

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I trust that the information contained in this submission is of value.

If you have any queries or comments regarding the contents of our submission, please contact ASFA's Principal Policy Adviser, Robert Hodge, on (02) 8079 0806 or by email rhodge@superannuation.asn.au.

Yours sincerely

Fiona Galbraith
Director, Policy