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4 September 2015

Australian Securities and Investment Commission
Att: Maan Beydoun
Email: maan.beydoun@asic.gov.au

Dear Maan,

Disclosure of fees and costs - draft Class Order amending CO 14/1252 and draft Regulatory Guide 97

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to ASIC's targeted consultation on the review of disclosure of fees and costs - draft Class Order amending CO 14/1251 and draft Regulatory Guide 97.

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 per cent of the 14 million Australians with superannuation.

1. Overall comments on the disclosure of fees and costs in Product Disclosure Statements (PDS) and periodic statements

1.1 <u>Achievement of underlying policy intent and desired policy outcomes</u>

ASFA strongly supports the underlying policy intent of transparent and consistent disclosure of fees and costs.

The complexity and diversity of the range of investment structures and options available causes inordinate difficulty and cost in complying and frequently results in inconsistent outcomes. There is a deal of confusion, among the industry, consumers and advisers, with respect to the disclosure of fees and costs.

Furthermore, there are differing views as to the extent of detail required to be disclosed, relative to any benefit derived by consumers. This is especially the case given the cost of producing some of the necessary information, the risk of inconsistent disclosure outcomes and the possibility of creating a false sense of precision among consumers.

Given this, we appreciate the difficulties faced by ASIC in drafting the Draft Class Order and revising RG 97. ASFA and the industry are keen to ensure that the final requirements are clear, able to be applied easily, keep additional costs to a minimum and, most importantly, produce consistent outcomes for consumers.

Accordingly, ASFA strongly recommends that a one day, or even two day, roundtable be convened in order to workshop the issues. By gathering a range of appropriate industry representatives in a room, with a whiteboard and butcher's paper, and allowing sufficient time, it should be possible to work through different investment arrangement and structures, identify issues and develop solutions.

Ideally such a workshop should be scheduled in October, to provide sufficient notice to enable the appropriate participants to be able to attend.

ASFA and the industry would be keen to support such an initiative, in the interests of developing a regime which produces consistent outcomes for members.

1.2 Need for consumer testing to be performed

Given the desired policy outcome of transparent and consistent disclosure to consumers, and in order to be able to perform the cost \ benefit analysis referred to above, comprehensive consumer testing should be performed.

The scope of the testing should include the extent to which consumers comprehend the disclosure and find it useful in comparing products and making decisions. The full spectrum of possible disclosure outcomes should be tested.

By way of example, different scenarios should be compared and contrasted. By way of example, two scenarios which could be compared would be

- all fees and costs are simply divided into direct fees charged to accounts and indirect costs deducted from returns on the way through the investment process; and
- fees and costs are further broken down into investment related fees and costs and non investment related fees and costs.

The results could then be examined to determine the extent to which the latter breakdown provides any more useful information to consumers than does the former.

1.3 Need for cost \ benefit analysis to be performed

It is important to bear in mind that this consideration of fees and costs is in the context of disclosure to consumers. It is not about the trustee's prudent management of the fund – it is about ensuring that what is disclosed to members in Product Disclosure Statements and in periodic statements is meaningful and useful.

Accordingly, once the workshop has identified the best approach, it is critical that this be assessed through the lens of consumer disclosure. It should be meaningful to consumers and, more importantly, not be misleading, including creating a false sense of precision.

Furthermore, complying with the fees and costs disclosure regime will necessitate funds incurring significant additional costs. These costs should be balanced against, and commensurate with, any benefits which are delivered to consumers. An analysis should be performed of the costs incurred compared with the benefits received and an assessment made as to the extent to which the additional costs are justified.

The final report of the Financial System Inquiry found that trustees need to reduce the costs of running their funds. Accordingly, any measure which increases costs significantly should be measured and assessed rigorously against the benefits which it is expected to deliver.

1.4 Current regime difficult to applying to variety of arrangements and produces inconsistent outcomes

The complexity and variety of the different arrangement and structures through which investments are made creates a number of difficulties in complying with the current approach. This will produce inconsistent results and lead to trustees having to incur unnecessary costs.

By way of example, where a “superwrap” trustee invests in a managed fund this produces a different disclosure outcome when compared to any other type of trustee. There does not appear to be a compelling policy rationale for treating platforms differently to other funds.

The annexure to the attachment contains examples of a variety of investment arrangements and structures and identifies some of the difficulties and complexities involved in complying with the current approach. The examples are of:

1. fund of funds investment
2. unlisted unit trust that invested in property market
3. property investment
4. infrastructure project investment
5. mandate investment in equity market.

1.5 Alignment with managed investment scheme disclosure

The disparity between managed investment schemes and superannuation funds is perpetuated under the current approach.

The misalignment between managed fund and superannuation fund disclosure includes the material differences between

- managed investment schemes management costs as compared to superannuation funds investment fees and indirect cost ratios;
- the treatment of transaction costs and investment costs.

By way of example, there is no compelling policy or practical reason for managed investment schemes to exclude transaction costs from the definition of management costs, and therefore from the indirect cost ratio (ICR).

These inconsistencies will only serve to confuse investors, particularly where they invest in what is essentially the same fund provided by the same product issuer, and create unnecessary difficulties and expense for trustees.

It is unclear why these changes being made and the differences between superannuation funds and managed investments extended. The is no clear underlying policy rationale which explains the differences in treatment and the effect on superannuation trustees is significant.

This could be resolved by aligning the disclosure regimes. How this is achieved, including whether the level of disclosure by managed investment schemes should be increased, is a matter which could be addressed during the proposed workshop. Such a decision should be determined after consumer testing has been performed and an examination of the cost \ benefit analysis - on both superannuation funds and managed investment schemes - has been conducted.

1.6 Introduction of materiality

ASFA members have queried as to why the current approach does not contain a concept of materiality. Incorporating materiality may be an appropriate method by which to strike a reasonable balance between disclosure to members and cost to funds.

ASFA members have indicated that this is critical, as otherwise they will need to outlay significant resources and effect system changes to identify, capture and store what frequently amounts to immaterial levels of cost, fees or expenses down the investment chain.

One member has suggested that in a meeting ASIC advised that standard materiality provisions would apply such that if the identified costs were less than 5% of the total costs of the investment option, no disclosure would be required.

Accordingly, a consideration of the possible introduction of materiality should be a matter which is considered at the workshop.

1.7 Specific issue such as related party transactions and offsetting arrangements

Arguably an alternative approach may be to focus on disclosure to consumers of: -

- the direct fees they will be charged to the consumer, by being deducted from their account\benefit;
- the indirect costs which have been deducted from returns on the way through the investment process;
- any related party transactions; and
- any negotiated "offsetting" arrangements whereby fees\costs are offset against investment performance.

1.8 Possible alternate approach

A significant amount of the complexity in the Draft Class Order emanates from

a) creating a definition for interposed vehicles; and
b) ensuring that, if managed assets are behind a derivative, the costs of these managed assets are captured.

We understand that ASIC is focused on these issues as it believes it has uncovered practices where product issuers have not been disclosing the costs associated with certain vehicles or derivatives.

The effect of adopting a prescriptive approach, with the ensuing complexity of the definition of interposed vehicle and the provisions with respect to derivatives, is that product issuers who have been make all endeavours to comply with the law will have to expend significant resources, including obtaining legal advice, to ensure that they interpret and apply the technicalities of the law correctly or risk inadvertent breaches.

It may be preferable to adopt a broader principles based approach, supported by the introduction of general anti-avoidance provisions similar to measures found in other regulatory regimes such as taxation.

Any fee or cost which the trustee charges or incurs of which it is aware, or should reasonably be aware, should be disclosed. If ASIC determines that a structure is created simply to conceal fees and costs behind a company, partnership, trust or derivative, with the consequence that these costs are not reflected in the fees or costs disclosed, the product issuer would be in breach.

1.9 Draft Class Order and draft revised Regulatory Guide 97

We have provided specific feedback and comments on the Draft Class Order and draft revised Regulatory Guide 97 in the attachment to this letter.

* * * *

We would be pleased to meet with you to discuss any aspect of the contents of this submission and would welcome the opportunity to work with ASIC with respect to this.

If you have any queries or comments regarding the contents of our submission, please contact Fiona Galbraith, Director Policy, on (03) 9225 – 4021 or 0431 490 240 or via email to fgalbraith@superannuation.asn.au.

Yours sincerely,

Glen McCrea
Chief Policy Officer

ATTACHMENT

2. Comments on the draft class order amending CO 14/1252 (Draft Class Order)

2.1 Consolidated version of Class Order 14/1252

The Draft Class Order amends Class Order 14/1252. Once the Draft Class Order is finalised it would be extremely useful if ASIC were to publish a consolidation of Class Order 14/1252 which incorporates the amendments effected by the Draft Class Order.

2.2 Need for adequate transition period

It is unclear as to the intended transition arrangements for PDSs to comply with the amended CO 14/1252:

- the Draft Class Order itself states at paragraph 5 that CO 14/1252 (pre amendment) continues to apply until the earlier of:
    - the date from which the PDS is required to apply CO 14/1252 (post amendment) after the commencement of the Draft Class Order; and
    - the date from which the PDS actually applies CO 14/1252 (post amendment) after the commencement of the Draft Class Order;

while

- paragraph 1 of the draft RG 97 states that the entire CO 14/1252 (as amended by the Draft Class Order) will apply to PDSs first given from 1 January 2016.

Accordingly, it will need to be clarified how to determine the effective dates for the application of CO 14/1252 (post amendment).

ASFA members have requested that there be a minimum 12 month implementation period from when the requirements in the Draft Class Order and RG 97 are finalised to the earliest date by which a fund's PDS must comply.

Complying with the requirements will necessitate significant changes to information technology systems and operational processes. This is especially the case given the significant effort which funds will need to make to determine interposed vehicles and the costs associated with investing in OTC derivatives. Funds will require sufficient time to be able to build and test the processes and systems to calculate the indirect cost ratio correctly.

Given the limited capacity caused by the need to implement other reforms the industry will require at least 12 months in which to implement these changes. Such an implementation period would provide sufficient time to perform analysis and assessment of the requirements; implement and review system and operational process changes; update policies and procedures and deliver training.

The 12 month transition period should only commence to run when the Draft Class Order and RG 97 are finalised.

Given that funds can roll a PDS at any time during the year, and generally roll annually, if the Draft Class Order and RG 97 are finalised in late Sept\early October as proposed then this will mean that funds which roll their PDS up to September\October 2016 will have less than 12 months to implement these changes.

Accordingly, if the Draft Class Order and RG 97 are finalised end Sept \ early Oct then ASFA recommends that a fixed date of 1 July 2017 as the final date by which to comply would be practicable. This would enable funds who roll-over their PDSs between July 2016 and June 2017 a period of a approximately 12 months to implement these changes (in fact for those who roll-over in July 2016 it will only be about 9 to 10 months). Of course funds could elect to opt-in early.

For periodic statements it would be reasonable for the amended class order to apply to statements which are issued on or after 1 January 2018. This will be with respect to periodic ("annual") statements for a reporting periods ending or after 1 July 2017 and with respect to exit statements for exit periods ending on or after 1 December 2017.

2.3 Ability to "opt-in" early to comply with CO 14/1252 as currently drafted

Funds should be able to "opt in" to complying with CO 14/1252 when they next issue a PDS, with the proviso that everyone must comply with the amended CO 14/1252 by the end of the transition period (ideally 1 July 2017).

Funds will need to have the ability to opt in to comply with CO 14/1252 as currently drafted, before the amendments made by the Draft Class Order taking effect, prior to the end of the transition period . Members have indicated that they would not want to have to reissue PDSs because the Draft Class Order has been finalised and has the effect of amending CO 14/1252.

It would be useful to have ASIC agreed the wording which could be shown anywhere a fund displays its ICRs during the transition period, which could be included in RG 97. By way of example, such wording could be to the following effect: -

- funds which have transitioned early - that they have transitioned early, and other funds may not have, and accordingly they may be showing a larger ICR for the same offering;
- funds which have not transitioned early - that indicates they have not transitioned, and that other funds may have, and accordingly they may be showing smaller ICRs for the same offering.

2.4 Ability to "opt-in" to part of CO 14/1252 as currently drafted

The Draft Class Order allows a trustee to opt in provided the PDS states that the Class Order applies to it. Similar provisions apply for periodic statements.

There does not, however, seem to be a provision which enables a trustee to opt in only with respect to the matters correcting drafting issues (sub-paragraphs 6(c) to 7 of the Class Order) before it is able to comply with the remainder of the Class Order. Ideally this should be enabled.

2.5 Buy sell spread for derivatives (paragraph 4(f))

The buy-sell spread concept for derivatives will create significant practical difficulties for fund, especially for those funds with a large number of derivative positions. For every derivative which a fund holds it will need to compare the "underlying return" of the "reference asset" to the actual return of the derivative.

This exercise will give rise to a number of issues, including the following.

- it will not always be a straightforward matter to identify the reference asset. A derivative may provide exposure to a number of reference assets and the range may change over time. Furthermore, there may not be a single reference asset or single pool of reference assets (e.g. with a swap where the value depends on the interaction of the values of multiple pools of reference assets);

- once the reference asset is identified, the fund will need to track changes in its value over time while the derivative is held. This is a significant, and costly, imposition. Furthermore, as discussed below, new funds will be required to disclose their reasonable estimate of indirect costs. This could require funds to estimate the performance of each reference asset to which it expects to be exposed for the period for which it expects to be exposed to each reference asset;
- the difference between the actual return and the underlying return is not a measure of the costs of the derivative. On the contrary, the comparison will be meaningless for many types of derivatives. This comparison assumes that there is a 1 to 1 positive correlation between the value of the derivative and the reference asset. Often this will not be the case. To the extent that the derivative may include leverage there will not be a 1 to 1 correlation. Instead there may be a negative correlation (e.g. the value of a put option increases as the value of the reference asset decreases). Equally, part of the cost of a derivative reflects the time value of money. This decreases as the derivative moves to maturity and is not correlated with the reference asset. Accordingly, the difference between the actual return and the underlying return is not a measure of the costs of the derivative.

2.6 New clause 101B - Definition of "interposed vehicle" (paragraph 4(h))

Despite there being some improvements in the definition, nevertheless it remains an extremely complex definition.

There is still a two-stage test, where the first test is an asset-based test and the second test is a purpose-based test.

ASFA members have raised three concerns with the asset-based test:

- it requires knowledge of the assets of each underlying entity. This is extremely onerous, time consuming and costly to achieve. Further, there is no guidance as to what a trustee can do where, despite making reasonable enquiries, it does not have sufficient information to be able to determine the assets of an underlying entity;
- assets are excluded if they are a means for investing in real property or confer control over another entity, however, there are exclusion from these exclusions if the underlying entity satisfies the asset-based test. This exclusion from the exclusion necessitates the adoption of a "bottom-up" approach as opposed to a "top-down" approach – i.e. trustees need to assess the bottom entity in an investment chain and work up through the chain;
- there is no clear policy basis for the exclusion where assets which are a means for investing in real property, but not, for example, in infrastructure.

ASFA would recommend either:

- removing the asset-based test as it is not necessary – the purpose based test is sufficient to still cover the field; or
- replacing it with a business-based test – in other words an entity is an interposed vehicle if its predominant business is that of making financial investments.

ASFA member have raised two concerns with the purpose-based test:

- where under the asset-based test an entity is not an interposed entity then the purpose-based test must be applied. What is essentially the same test has different formulations with respect to listed and unlisted entities. It may be that the different formulations are designed to reflect that, while most listed assets are not interposed vehicles, most unlisted assets are interposed vehicles, the difference in formulation merely creates more complexity with no appreciable difference;

- the purpose-based test relies on disclosure in a PDS, however, there is no guidance as to how disclosure can affect the outcome.

  By way of example PDSs may offer: -
    - a pre-mixed / blended options (e.g. balanced, Australian equities) which do not name particular assets;
    - a single asset investment option which will name a particular managed fund, exchange traded fund or LIC but not disclosure any underlying investment vehicles.

  It is not clear how this disclosure affects whether an entity is reasonably regarded as the end investment or as the means of accessing the end investment. A mandate which invests in listed securities which are in infrastructure is designed to provide exposure to infrastructure. It does not appear to be appropriate to be picking up the costs of every listed investment in this scenario, as the method of investing was chosen to gain exposure to infrastructure while maintaining liquidity and being more efficient.

ASFA would recommend that the purpose-based test be amended by:

- amalgamating the listed and unlisted tests into one test – is it
    - the end investment - and as such it is not an interposed vehicle; or
    - the means of accessing the end investment – and as such is an interposed vehicle
- removing the reference to “having regard to the PDS”.

Members have queried why an entity which invests in real property is not considered to be an interposed vehicles, as they are a vehicle by which a fund would gain exposure to investment in property.

Notional sub-clause 101B(4) deems certain entities to be interposed vehicles.

Listed entities will be deemed to be interposed vehicles if the entity "could not be reasonably regarded as the investment of the [investor], rather than the means by which the benefit of investments by or through [the entity] is obtained". Unlisted entities will be deemed to be interposed vehicles if, amongst other things, the entity "could be reasonably regarded as the means by which the benefit of investments by or through [the entity] is obtained, rather than the investment of the [investor]. This distinction is unclear and unlikely to make any meaningful difference as to how these clauses are interpreted and applied. If it is intended that a higher onus be placed on unlisted funds rather than listed funds this should be done more explicitly.

Notional sub-clause 101B(4) deems an entity to be an interposed vehicle where it is a means to obtaining benefits of underlying investments. There is no carve out for property assets. This creates an anomaly between notional sub-clauses 101B(1), (2) and (4). Property securities are carved out from the calculation in sub-clause (1) by the operation of sub-clause (2), however, sub-clause (4) makes no distinction between property and non property investments. This may not have been the intended outcome.

Specifically, with respect to drafting, we recommend that: -

- sub-clause (2) – real property should be defined
- sub-clause (4) - needs to be reworded to make the meaning clearer.

2.7 Indirect costs (paragraph 4(i))

The Draft Class Order requires the ICR to be disclosed in a PDS for existing funds is to be calculated based on costs incurred in the previous financial year and for new funds is costs estimated for the next year. This conflicts with the requirements that an investment fee (including a performance fee) must use forward estimates if the previous financial year's costs are not reasonable. This will make it impossible to compare products on a "like for like" basis as the components of fees will not have been calculated in a consistent way.

For the sake of consistency it is preferable for all fees and costs to be disclosed on the same basis for all funds.

There may be instances, however, where a product issuer is aware, at the time of issuing a PDS, that the previous year's information would not be a reliable indicator of present or future indirect costs and there is a risk that it may be materially misleading. This could, for example, be as a result of material changes in such matters as asset allocation, investment arrangements or other operational or administrative processes towards the end of the previous financial year. Performance fees for private equity can be lumpy.

When it is known that a fee is not appropriate to carry into the next year (e.g. the trustee is no longer holding an interest in a trust or has moved from a trust structure to a mandate structure) using last year's fees can mean that fees end up being counted twice.

Furthermore there may be an issue with the gearing levels of managed investment schemes. These can be dynamic, as the managed investment scheme manager may reduce gearing to be conservative, in a similar fashion to funds with a variable cash holding increasing the percentage of cash to become more conservative. This can significantly affect indirect costs.

In such circumstances there should be an exception which would permit the product issuer to make a reasonable estimation. The rule should not be that the trustee must use prior year information – it should be that the trustee must use prior year information in determining the components of indirect costs unless the trustee has a reasonable basis for determining that prior year information for a particular component would not be appropriate.

Further, if a PDS is to be issued on 1 July, this information with respect to the previous year will not be available.

ASFA recommends that the Draft Class Order, with respect to Schedule 10, subclause 104(2), where to use the previous year's indirect costs would, in the product issuer's reasonable opinion, make the PDS misleading and deceptive, the product issues should be able to use a reasonable estimate of future indirect costs.

With respect to drafting – we recommend that new sub-clause (3A)(b) should define "financial market".

2.8 The definition of "administration fee" and "investment fee" (paragraph 4(j))

Members have sought clarification on the reference to "other than indirect costs that are not paid out of the superannuation entity".

The Draft Class Order amends the definitions of "administration fee" and "investment fee". The SIS Act, however, contains definitions of "administration fee" and "investment fee" for MySuper.

These new defined terms appear to be inconsistent with the defined terms in the SIS Act in relation to the rules about how to establish a MySuper product (investment option).

These amendments in the Draft Class Order will result in a divergence between the definition superannuation funds with a MySuper product must apply under the law and the definition they must disclose in a PDS. We query the inconsistency with the SIS terminology and recommend that this should be reversed.

2.9 <u>"Investment fee" definition (paragraph 4(j))</u>

The amendment to the definition of "investment fee" is a significant change.

The inclusion of the words "other than indirect costs that are not paid out of the superannuation entity" will exclude from investment fees amounts which many superannuation trustees would consider to be, and currently disclose as, investment fees. Amounts can only be indirect costs to the extent that they are not charged to members as a fee but would reduce the return on an option.

This means that legally, if an amount is a fee it cannot be a cost.

The definition of "investment fee" makes it quite clear that it includes the payment of fees by the Trustee for the management of investments and other costs incurred by the Trustee which are not indirect costs. Accordingly, this would capture fees (whether management fees or performance fees) which are paid out of the fund property to an interposed entities.

Accordingly it is circular to refer to "indirect costs" in the definition of investment fee.

RG 97 at paragraph 65 states that *any* fee for an interposed vehicle charged to the trustee should be an indirect cost but the Draft Class Order does not support this. This should also be contrasted with the position stated in paragraph 83 of RG 97.

2.10 <u>Fee example</u>

Changes have been made to the fee example, presumably to make the example more flexible for those superannuation products which do not offer a MySuper product, for example an income stream product.

The Draft Class Order, however, does not contain any instructions as to how the fee example should be completed. Ideally there should be confirmation that the trustee is to insert either MySuper or another investment option but is not required to do both.

While we note that references to MySuper have been replaced in the heading and preamble, however, references still remain in the table. All references to MySuper should be amended.

Further, we note that buy/sell spreads must now be set out in the note to the fee example, however, the table requires a buy/sell spread. Further, a reference to the buy/sell spread costing $X could be misleading as account balances are usually valued at the sell price.

The new note to the fee example creates further disconnects between superannuation disclosure and managed fund disclosure, which has to provide a fee example but does not need to disclose a buy/sell spread.

2.11 Consumer Advice Warning

2.11.1 MySuper products

For MySuper products the only type of superannuation fee which could be included in the Consumer Advisory Warning (CAW) as suitable for negotiation is “administration fee” and only the employer is able to negotiate a lower administration fee.

MySuper products are required to charge the same fees (flat, percentage or combination of both) for all fee types for all holders of the product under section 29VA of the *Superannuation Industry (Supervision) Act 1993* (SIS) exception of

- administration fees - which may be exempted under sub-section 29VA(8) and section 29VB of SIS with respect to all employees of an employer-sponsor), and;
- investment fees - for lifecycle investment options across a maximum of four cohorts of MySuper members under sub-section 29VA(9) of SIS.

It is only employer-sponsors who are able to negotiate administration fees -it is not correct to state that a member can negotiate [any] fee.

Accordingly, for MySuper products, we recommend that the CAW states “Your employer may be able to negotiate to pay lower administration fees”.

2.11.2 Non My-Super products

Members of non-MySuper superannuation products may be able to negotiate a range of fees including administration, investment, insurance and activity fees. This would necessitate a separate CAW for non MySuper products.

The reference to “your employer” in the revised CAW for superannuation products is not universal - it is really only relevant to employer sponsored superannuation products and not those which do not accept employer contributions.

Accordingly, a trustee should be able to either

- omit the words “or your employer” if they are not applicable to that product; or
- insert the words “as applicable,” between “employer” and “may”. This is consistent with the CAW for managed investment products where the corresponding sentence includes “where applicable” at the end.

In addition, to avoid giving the impression that all fees and costs are negotiable, a trustee should be able to indicate which fees are negotiable as provided for in the following sentence: “You [or your employer] may be able to negotiate to pay lower [investment/administration/switching/exit] fees.”

2.11.3 Pension products

Finally, the consumer advice warning refers to “your employer”, however, this does not apply to pension products. Consideration should be given to different requirements in the template for accumulation and pension products.

2.12 Periodic statements and “indirect fees”

The Draft Class Order creates a new requirement to disclose an additional item for periodic statements - the dollar value of “indirect fees”. This introduces the new concept of indirect fees without ascribing a meaning to it and, as such, it is not clear which fees are intended to be captured by this new concept.

It is important to note that this terminology is not defined or used elsewhere in the Corporations law and is not disclosed in the PDS. The Draft Class Order amendment does not describe the amount which must be included for indirect fees, as it does for indirect costs.

The amendments clearly anticipate two separate dollar amounts be disclosed, one for indirect costs, the other for indirect fees. These changes unnecessarily lengthen and complicate periodic statements and, more importantly, have the potential to confuse consumers.

To ensure that all indirect fees and costs, which are not paid directly from a member’s account but reduce returns, can be disclosed in periodic statements in a clear and concise manner, they should be combined into one amount of indirect cost.

Importantly, consumers are already frequently confused about the concept of indirect costs, especially as it is disclosed as a dollar amount, and are under the misapprehension that they are charged these costs directly, as opposed to reflecting the amount by which returns have been reduced. Creating a concept of “indirect fees” will only serve to exacerbate this confusion.

Members’ periodic statements would already disclose the amount representing “indirect fees” in the existing “indirect costs” item – i.e. periodic statement disclosure includes a single amount representing indirect costs, which includes “indirect fees”.

Further, the Draft Class Order replaces clause 301(1), which contains the prescriptive wording for periodic statements, but does not amend clause 301(2), which describes the amount to include in relation to the prescriptive disclosure. There is no guidance as to how to calculate the dollar amount for indirect fees, as opposed to indirect costs.

ASFA recommends retaining a single indirect cost item, possibly with wording describing that indirect costs may include fees which the trustee has incurred.

3. Comments on the draft revised Regulatory Guide 97 – Disclosing fees and costs in PDSs and periodic statements (RG 97)

3.1 <u>Comments on specific paragraphs</u>

With respect to the draft revised RG 97, we make the following observations.

Paragraphs 25 and 27

These state that Class Order 03/237 (CO 23/237), which allows an update to non-materially adverse PDS content via a source such as a website, does not apply to the short-form, eight page, PDSs. The industry, however, has always been of the view that it does apply.

It is not apparent from the face of CO 03/237 as to why it would not apply to short-form PDSs. In any event ASFA does not believe that there is any clear or compelling policy reason as to why CO 03/237 should not apply to short form PDSs and recommend that RG 97 be amended to confirm that it does.

Without the ability to rely on CO 03/237, or a materiality threshold or safe harbour, a requirements to update a PDSs every time information changes, or otherwise becomes out of date, would necessitate considerably more frequent PDS rolls than would otherwise be the case. This would cause significant and unnecessary additional costs and divert resources from product development, stifling innovation.

Paragraph 27

This refers to updating PDSs annually. It is important to note that, while many funds do this, there is no legal obligation to do so and in fact this was a conscious policy decision as part of the move from the more prescriptive Key Features Statements to PDSs.

Accordingly this reference should be removed.

Paragraphs 29 to 37

The combined effect of these paragraphs for existing funds is that indirect costs are to be calculated based on the previous financial year, whereas fees are to be calculated based on the amounts payable "currently" or on an "ongoing" basis.

This difference may prove to be problematic, as fees and indirect costs will be presented together in the fee table and worked example and ideally should be calculated on a consistent basis. Having a different basis for calculation is likely to lead to confusion.

Furthermore it could give rise to anomalies in particular situations. By way of example, where an amount moves from being an investment fee to an indirect cost (e.g. where the trustee replaces a direct mandate with an investment in a third party fund) the costs of that arrangement may cease to be a fee and become an indirect costs. This will cause the investment fee to decrease immediately but the indirect costs will not increase until after the end of the financial year.

Paragraph 45 onwards

Members have advised that the examples of interposed vehicles are of limited use and that further and different examples are necessary. ASFA would be happy to work with ASIC with respect to this.

Paragraph 50

The description of notional sub-clauses 101B(1) and (4) is inaccurate. This paragraph says that an entity will not be an interposed vehicle where it is the end investment and not a way of accessing an investment but this simply reflects the deeming under notional sub-clause 101B(4). Even if an entity is not deemed to be an interposed vehicle under notional sub-clause 101B(4) (i.e. because it is the end investment) the entity could still be an interposed vehicle under notional sub-clause 101B(1).

Paragraph 58

This paragraph only contemplates looking through two layers of interposed vehicles. If it is intended that responsible entities need to look through multiple layers of interposed vehicles indefinitely, until the end of the investment chain, then this should be specified explicitly in this paragraph.

Paragraph 59

Members have questioned example 9, with respect to A-REIT. They have observed that, while its clear that the A-REITs do not have 70% of their assets in the relevant securities, it is difficult to see how the A-REIT can be classified as the end investment, as opposed to the real property which is held by the A-REIT.

Paragraph 65

This states that indirect costs includes "*any fee for investment … that is charged to the trustee by the operator of an interposed vehicle*."

Based on the rest of RG 97, however, whether that statement is correct would depend on where and how the fee was charged. If the fee is: -

- charged within the interposed vehicle or its assets - the fee would be an indirect cost; but
- paid by the trustee from superannuation fund assets – the fee would be an (indirect) investment fee.

This needs to be clarified and made consistent.

Paragraphs 72 – 80

Over the Counter (OTC) investments can be bespoke instruments and work in a wide variety of ways. Members have observed that the example provided is just one example of how to calculate fees but that guidance is necessary with respect to other types, even if this takes the form of confirming that trustees are able to design their own methodologies, based on the nature and design of each instrument.

Buy sell spreads for OTC derivatives are required to be included in the indirect cost calculation.

Determining the cost of an OTC derivative (i.e. the difference between the cost of acquiring the derivative and immediately selling it) is near impossible to determine, as brokers and counterparties are reluctant to provide this information.

Such a difference is not easily determined by brokers and counterparties. Only Australian managers could be legislated to provide this information - managers in foreign jurisdictions are likely not to be prepared to provide this information. As this difference would represent proprietary intellectual property \ commercial in confidence information counterparties would not want the amount they are including known.

Brokerage costs of the over the counter (OTC) derivative is information which is not readily available, as often brokerage is not itemised in OTC reporting and would necessitate significant system changes, time and cost to be able to identify, store and include this information in calculations.

Further, members have indicated that the examples did not clarify precisely what are the requirements nor does the reference on paragraph 74 to 1 percent assist in the interpretation \ application of this provision.

In particular, the exemption for managed investment schemes from the requirement to disclose 'brokerage' for OTC's used for hedging purposes (on the basis that these costs fall within transaction costs and are excluded from the calculation of management costs) largely is unhelpful. Any managed investment scheme which holds superannuation monies will be required to report this information to the trustee anyway.

Accordingly, these disclosure obligations should be aligned – ideally by extending the exemption to superannuation. If this requirement is not removed it is recommended that the commencement of the class order be delayed 12 months to enable trustees to negotiate appropriate arrangements for this information to be provided.

Paragraph 78

The scenario on which the example in this paragraph is based illustrates the difficulties of complying with these requirements.

For an existing fund, indirect costs will need to be calculated for the previous financial year. This will involve tracking the price of gold through the financial year and comparing it to the value of the derivative. It is not clear how the disclosure should be adjusted if, for example, the fund negotiates different fees for the derivative such that last year's figures are no longer relevant.

For a new fund, the fee would need to be estimated for the year ahead. This would involve projecting the price of gold throughout the coming financial year, presumably also factoring in the possibility that the derivative would not be held for the whole year.

These details would arise in respect of every derivative, however, the regulatory guide does not address the complexity of these issues.

Paragraph 79

This guidance appears to relate to notional sub-clause 101A(3) which was introduced in Class Order 14/1252 but which is to be replaced by paragraph 4(f) of the Draft Class Order, which introduces a new notional sub-clause 101A(3).

In any event, this paragraph requires entities to include as an indirect cost the difference between the acquisition price for a derivative and the price to close out the derivative immediately. If the fund does not intend to close out the derivative immediately it is not clear why this cost needs to be included.

This paragraph also suggests that buy/sell spreads are not indirect costs, however, it is not clear whether this is at the top level only or whether it also includes the buy/sell spreads of all interposed vehicles.

Paragraph 83

It is not consistent to report performance fees paid to a manager as an indirect cost while the management fee paid to the same manager are reported as an investment fee.

Paragraphs 85 and 86

These paragraphs highlight the different basis on which fees and indirect costs are disclosed.

Fees are disclosed on a "current" basis (i.e. projected for the coming year) whereas indirect costs are disclosed on a historical basis. This distinction is unlikely to be understood by retail clients.

The regulatory guide does not explain the basis for this distinction and how it furthers good disclosure outcomes.

Paragraph 86

The paragraph states that “it will often not be reasonable to estimate that performance fees will not [sic: “not” should be deleted] remain at their previous level …”.

Members have advised that, in their experience, it is extremely difficult to estimate performance fees and in many cases using the previous year’s performance fees, or an average of past years performance fees, is frequently the best option. They have requested guidance as to whether ASIC had any particular scenarios in mind where it would not be appropriate to use past figures, or any particular reasons as to why it will “often” not be reasonable. If so, we recommend that these scenarios could be included in the guidance.

Paragraph 109

This paragraph represents a significant departure from the existing regulatory guide and industry practice. This change would have significant flow on consequences for the industry.

It is common for trust deeds and constitutions to prescribe maximum fees for all classes of member and for the PDS to specify precisely the fees currently applicable to particular members. This is sufficient to ensure members pay only those fees which have been disclosed to them. Changes to fees are dealt with through the regulated significant event notice process.

By way of contrast, this paragraph requires a PDS to calculate fees based on the maximum fees in the trust deed or constitution unless there is a "binding arrangement not to apply the maximum". It is not clear what is meant by a binding arrangement in this context. In particular, the regulatory guide does not specify whether an arrangement will be binding even if the trustee has the ability to amend it from time to time. Furthermore, if a fund never intends to charge the maximum fees under the constitution or trust deed, it is not clear why disclosing the maximum provides a better disclosure outcome for retail clients.

Paragraph 124

We anticipate that most superannuation funds would disclose the management fee in this example as an investment fee rather than as an indirect cost. It would be preferable to have an understanding of why it is considered to be a better disclosure outcome to have this disclosed as an indirect cost.

Paragraphs 133 and 134

As with paragraphs 85 and 86, these paragraphs highlight the different time periods over which fees and costs are calculated, without explaining the rationale for this difference.

Paragraph 169

This paragraph introduces the concept of an "indirect fee". The only other place this concept is used is in paragraph 4(n) of the Class Order, which neither defines nor explains it. It is not clear when a fee will be direct or indirect, or even when it will be an indirect cost.

Paragraph 170

The guidance would be clearer if it stated that periodic statements should itemise administration costs; investment costs; other direct costs, such as advice fees and switching fees and then provide separate disclosure regarding indirect costs. The disclosure with respect to indirect costs should include the fact that these are not fees which they pay directly though a deduction from their account \ balance but instead represent a reduction in the value of the earnings credited to their account – either as interest or a unit price.

Paragraph 171

It should be noted that reserves are not required to be disclosed in periodic statements – the obligation requirement is to disclose movements in reserves in the annual report.

3.2 <u>Indirect costs and buy/sell spreads</u>

Members have indicated that it would be useful if RG 97 were to provide guidance confirming that in PDSs indirect costs amounts should not include amounts that are covered in any disclosure for “buy/sell spreads” if this would lead to double-counting.

3.3 <u>Frequency of calculation of estimated fees and costs</u>

Members have indicated that it may be helpful if RG 97 were to provide guidance as to how frequently the trustee is expected to calculate the “estimated indirect costs”, “estimated investment fees” and “performance based fees” to ensure that the disclosed costs contained in the PDS are still reasonable?

3.4 <u>Partial investments</u>

Members have noted that there is no guidance with respect to the appropriate methodology to employ when apportioning costs with respect to investments which are partially held and have suggested that this may be useful.

3.5 <u>Fee template – “Other fees and costs” row</u>

Members have indicated that it would be extremely useful if RG 97 were to provide guidance on how to complete the ‘Other fees and costs’ row in the fee template.

4. Drafting issues

4.1 Class Order

Paragraph 4(f)

In notional sub-clause 101A(3A), in the definition of "reference asset", the word "ultimate" should be "ultimately".

Paragraph 4(h)

Notional sub-clause 101B(2) provides that certain assets are to be disregarded for the purposes of the 70% calculation. It should be clarified whether such assets should

- simply not be treated as securities or financial products (i.e. excluded from the numerator only); or
- should be completed disregarded (i.e. excluded from both the numerator and denominator).

The drafting of the opening words of notional sub-clause 101B(4) need to be clarified.

Notional sub-clause 101B(5) provides exceptions from the definition of interposed vehicle in notional sub-clauses 101B(1) and (2) for IDPSs and similar products. These exceptions should also apply to the deeming in notional sub-clause 101B(4). We understand that ASIC has identified this issue and will correct it when finalising the class order.

4.2 Regulatory Guide

Consistency of terms

Ideally consistent terms should be utilised throughout the Regulatory Guide.

Throughout the Regulatory Guide there are references to the managed investment scheme which issues the PDS which include

- “registered managed investment scheme”;
- “registered scheme”;
- “managed investment products”;
- “managed investment product option”.

Similarly, “interposed vehicle” / “interposed entity” ideally should be one term used consistently.

Further, often the term “indirect cost ratio” is used when referring to “indirect costs” both for superannuation products and managed investment schemes. The “indirect cost ratio” for managed investment schemes, however, has a different definition - “the ratio of the management costs for the option that are not deducted directly from a product holder's account, to the total average net assets of the managed investment scheme that relates to the investment option”. Given this, it is not appropriate to use “indirect cost ratio” as a generic term as it is misleading to apply the superannuation term with respect to managed investment schemes.

Paragraphs 1 to 3

In respect of transition, the regulatory guide refers to Class Order 14/1252 both before and after the amendments proposed by the Draft Class Order. This makes the guidance difficult to interpret and apply.

Paragraph 24

The cross reference should be to paragraphs 36 and 37.

Paragraph 30

This paragraph appears to be combining a number of distinct concepts. It combines discussion of indirect costs disclosure for new and existing funds and disclosure of fees. The references to "investment fee" should be removed from this paragraph, as this is dealt with in paragraphs 33 to 35.

Paragraph 36

Indirect costs ratio should express indirect costs as a percentage of net assets, rather than as a percentage of total costs.

Paragraph 42

In the second sentence, the first occurrence of the word "these" should be removed.

Paragraph 43

The reference to "a vehicle that is not an interposed vehicle or a business venture held by a non interposed vehicle" is unclear and should be clarified. The examples of a mine or airport should be expanded.

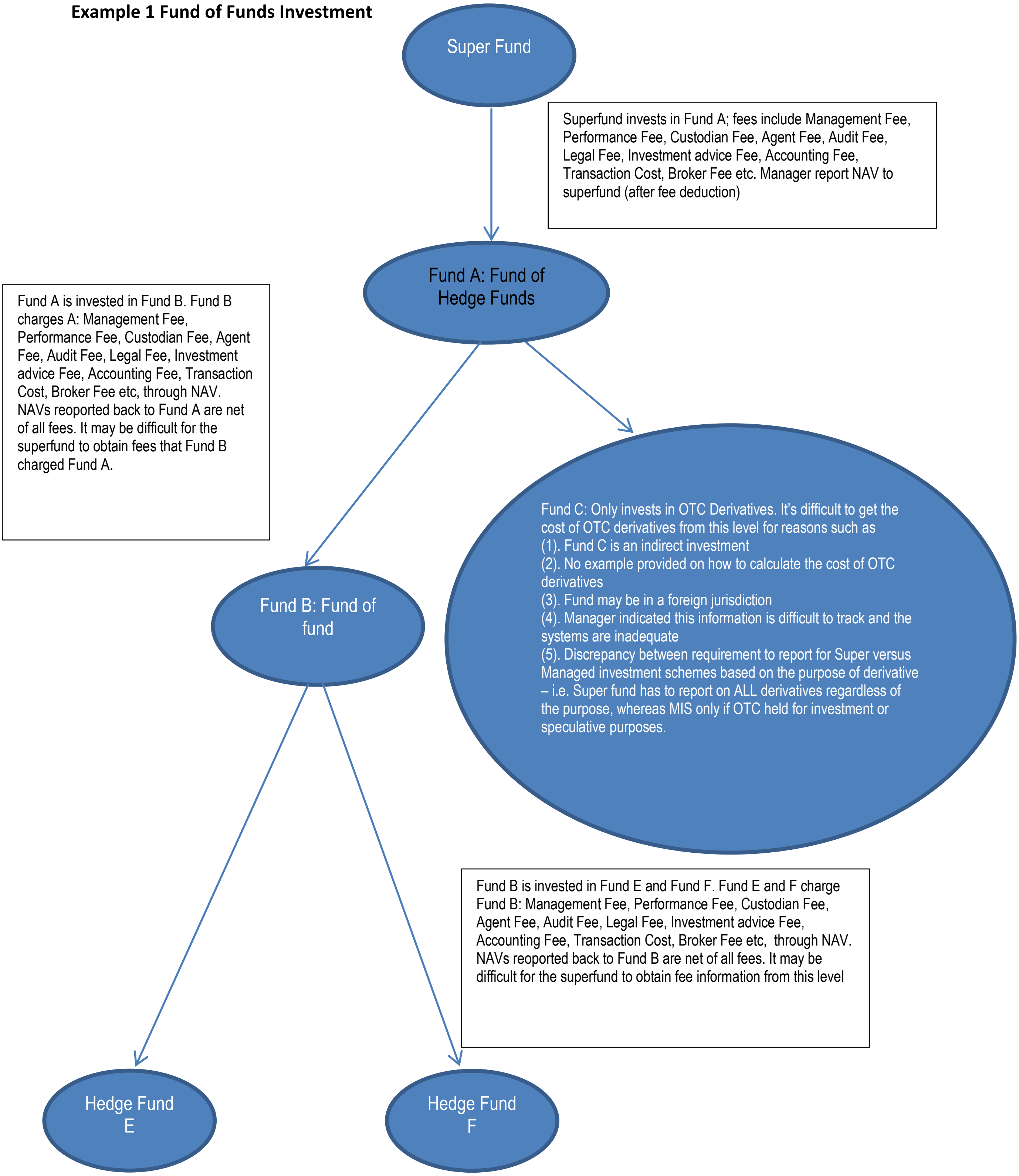
Paragraph 129

The words "When disclosing how and when in relation to switching fee" are unclear and should be clarified.

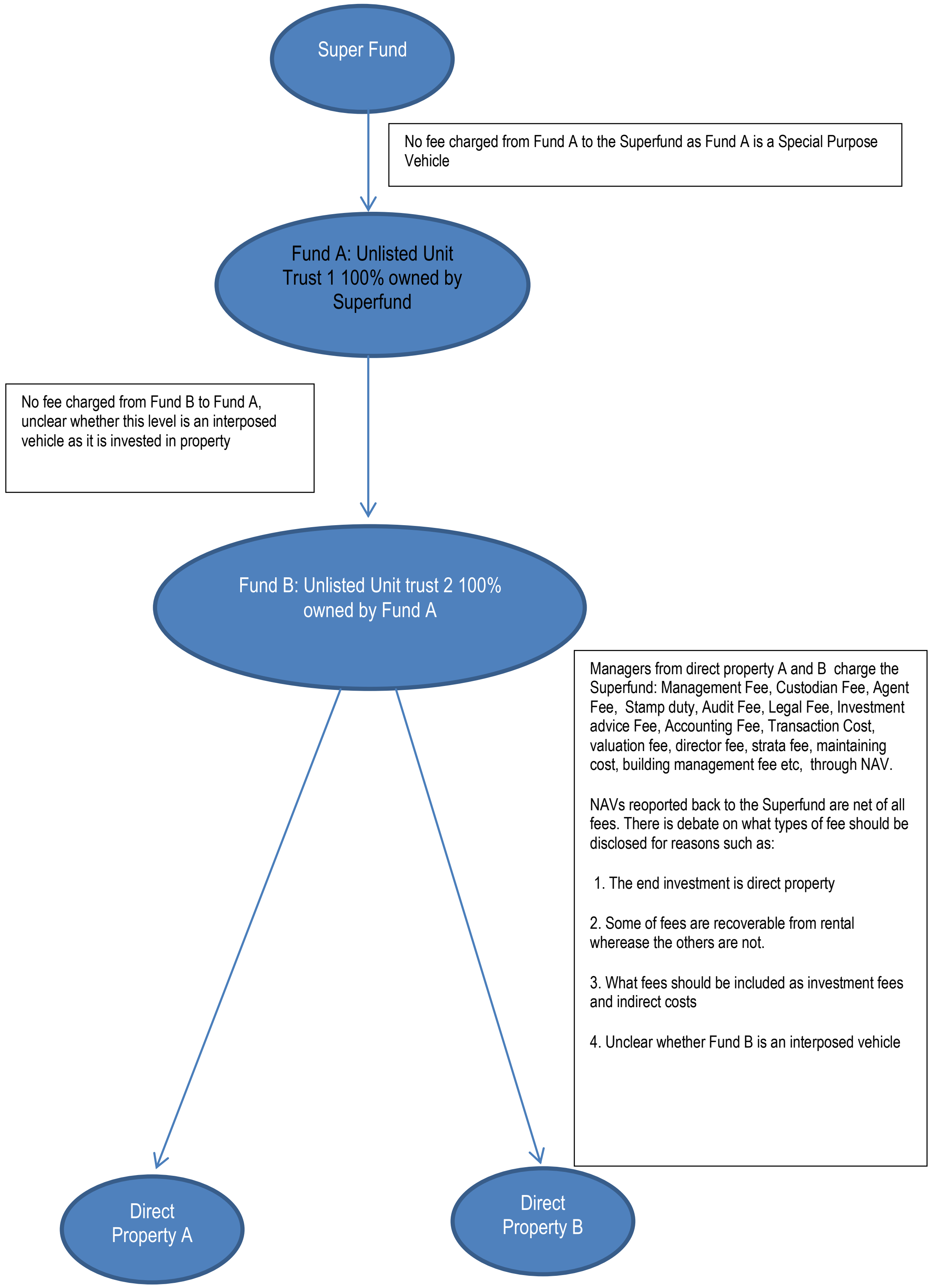
* * * *

ANNEXURE

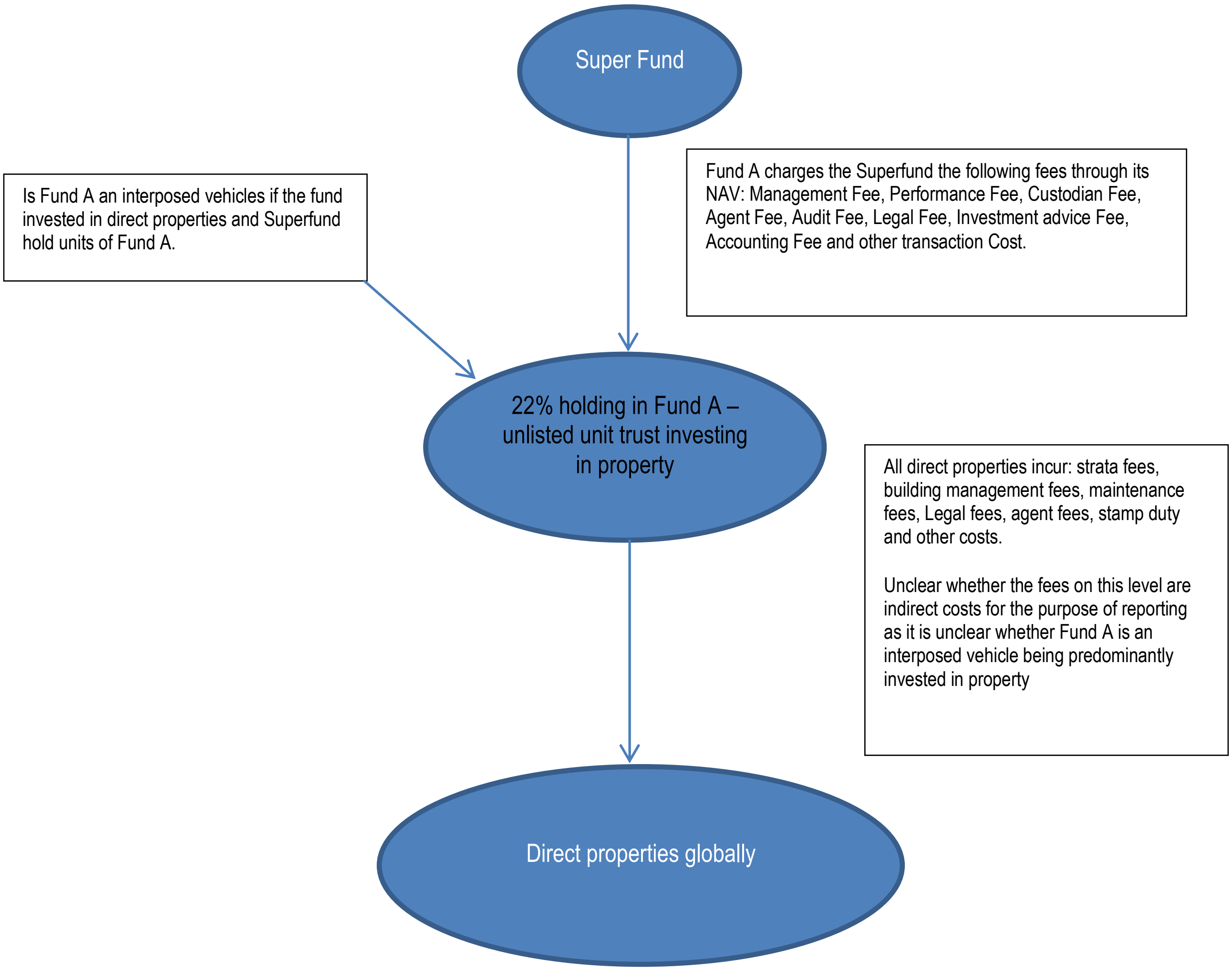
Example 1 Fund of Funds Investment



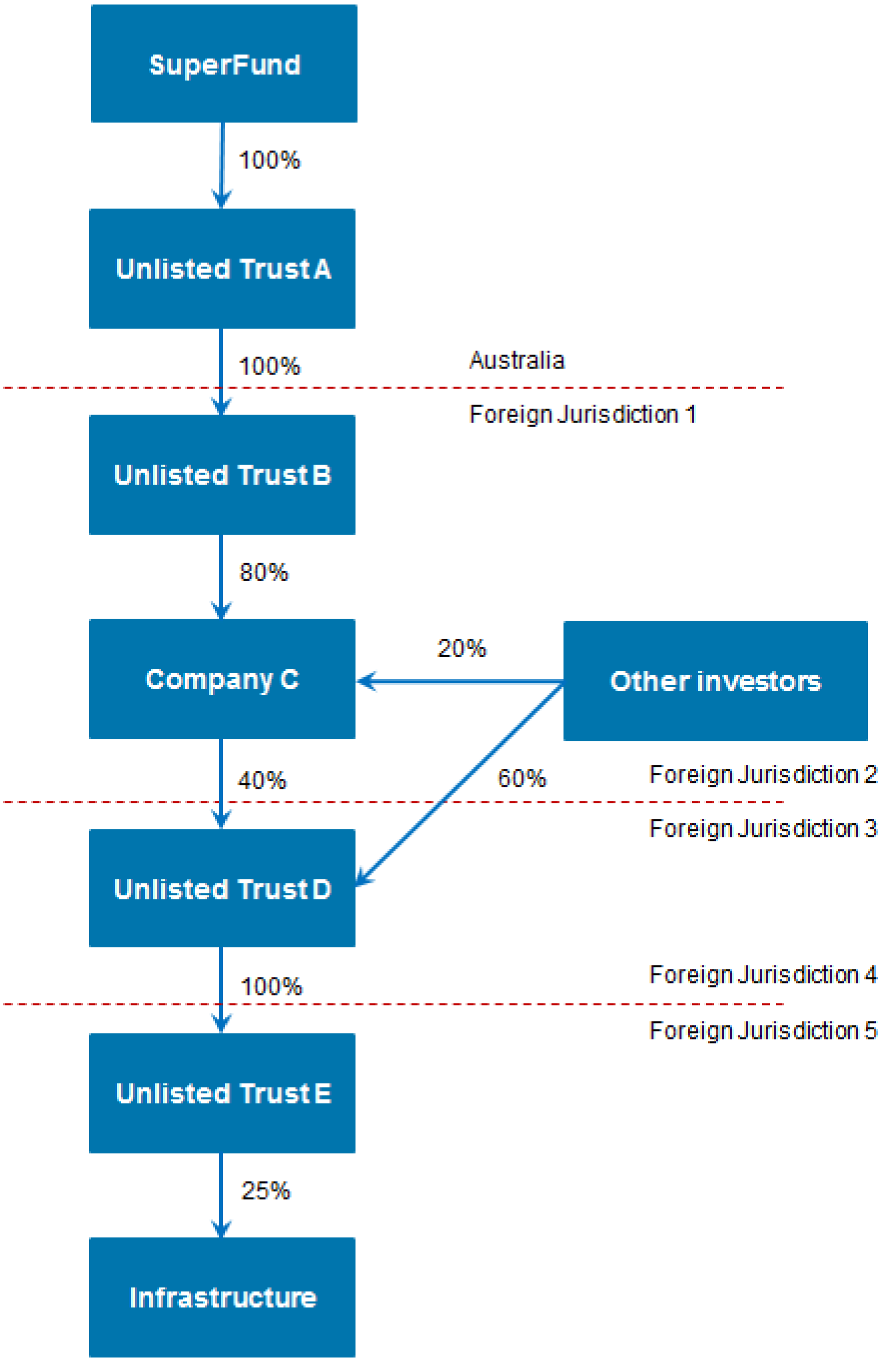
Example 2 Unlisted unit trust that invested in property market



Example 3 Property investment



Example 4: Infrastructure project investment



The challenge of above example is there are many investment levels within the structure and they all belong to different foreign jurisdiction. Some of the levels the superfund is the sole investors whereas other levels there are more than 1 investor. Each level of investment may incur Management Fee, Performance Fee, Custodian Fee, Agent Fee, Audit Fee, Legal Fee, Investment advice Fee, Accounting Fee and other transaction Cost etc. The bottom level - the direct infrastructure investment - also may incur project management cost and other unknown fees. It is hard to identify which levels of the structure should be recognise as an interposed vehicle and what type of fees that the superfund is required to disclose. The second challenge is it is very difficult to get information from any levels below the Unlisted trust A for reason 1. They are not directly related to the superfund 2. They all report NAV to the holding portfolio net of fees 3. They all sit under different jurisdiction.

Example 5: Mandate investments in equity market