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Maan Beydoun
Senior Specialist, Investment Managers and Superannuation
Australian Securities & Investments Commission
Level 5, 100 Market Street
SYDNEY NSW 2000

Email: feeandcostdisclosure@asic.gov.au

Dear Maan

Submission on Draft Regulatory Guide 97

The purpose of this submission is to provide feedback on the draft 'Regulatory Guide 97 - Disclosing fees and costs in PDSs and periodic statements' released on 12 December 2014.

We consider that most of the draft Regulatory Guide 97 (RG 97) represents a major improvement on current guidance relating to the disclosure of fees and costs. The proposed changes, along with our suggested enhancements, should ensure that the disclosure of fees and costs is much more comparable between funds than is currently the case. Some particular changes that have improved disclosure are the following:

- the requirement to include all indirect costs in the fees and costs template and not simply include some indirect costs in notes (RG 97.41)
- the explicit disallowance of income sharing to reduce fees and/or costs (RG 97.44)
- ensuring that any additional information on how fees or costs are recovered is excluded from the fee template (but disclosed elsewhere) to avoid unnecessary confusion (RG 97.76)
- the use of examples greatly assists in understanding the application of certain requirements.

ASIC has sought comment from industry participants on specific questions concerning some of the key revisions. Our responses to selected questions are shown below.



Feedback Questions

Interposed Vehicles

B1 Q1 Do you consider the guidance provided on the interposed vehicles to be sufficient to properly explain when a body, trust, partnership or other structure would be an interposed vehicle?

The guidance on what constitutes an interposed vehicle is reasonably comprehensive and the use of examples helps to illustrate how the requirements should be applied in several different scenarios. But more explanation should be added in relation to the different treatment of listed and unlisted entities that may be quite similar in all other respects. ASIC should also be aware that categorising unlisted entities as interposed vehicles but listed entities as not, may drive fund behaviour. Funds may move some of their investments in property, infrastructure and private equity from unlisted to listed vehicles, or may even create listed vehicles from their unlisted vehicles, in order to lower their disclosed costs (even though the true costs of each investment may be very similar). Such behaviour may not be in the best interests of members as listed vehicles tend to have greater volatility in returns.

B1Q2 Are there additional examples that you consider should be included in RG 97 which would assist in clarifying or explaining the interposed vehicle definition and its application?

The examples provided are appropriate, with most including the rationale for why the entity should be treated as an interposed vehicle (or not). However, for the examples that do not include such a reason, the reason for treating the entity in such a way should be added.

Further examples should also be added to make explicit the different treatment of listed and unlisted entities of a similar asset class (eg. property and infrastructure).

Also, Example 5 seems to miss a negative as the final sentence should read 'This company is not an interposed vehicle because it is listed and **does not** predominantly invest in securities or financial products.'

B1Q3 The application of interposed vehicles and indirect cost varies between superannuation products and managed investment products. Do you consider the proposed RG sufficiently explains these differences?

We understand that the different treatment of transaction costs for superannuation products and managed investment products is due to the different definitions of indirect costs (superannuation funds) and management costs (managed investment products) but this should be explicitly stated. At some point the management costs definition should be aligned with the new indirect costs definition, as there seems to be no reason why the transaction costs for these two types of products should be treated quite differently.



Reasonable estimates of indirect costs

B1Q4 Do you consider the guidance provided on the requirement to reasonably estimate indirect costs would assist you in complying with this requirement?

It is very important to enable trustees to use a reasonable estimate of indirect costs as these costs are often not known to the same level of precision as fees. The provision of a reasonable estimate is much better than no disclosure of such costs at all, on the grounds that they cannot be precisely determined. However, more guidance should be provided on what constitutes a 'reasonable estimate' and what does not. Ideally this should be quantified, eg. a reasonable estimate may be determining an indirect cost to a level of accuracy of approximately 5%, or some other degree of accuracy appropriate to the circumstances. Guidance should also be provided in cases where a fund manager does not provide any assistance in the calculation of the 'reasonable estimate' of their indirect costs.

RG 97.91 requires that the indirect costs from the previous financial year should be disclosed but the clauses covering a 'reasonable estimate' (RG 97.34-39) do not refer to this at all. These clauses should make it clear that the estimation required is for costs already incurred that cannot be precisely known rather than estimating costs in the future time period.

The requirement to update indirect costs when a better estimate is available should only apply where there is a material difference in the estimates, as estimates will regularly change throughout the year (usually by small amounts). Once again, guidance may need to be provided on the materiality threshold which could be a change of say 5%, or some other degree of accuracy appropriate to the circumstances.

B1Q5 Do you agree that it would be a matter of good practice for trustees and responsible entities to document their procedures for making reasonable estimates as a means of enhancing consistency?

Trustees should not simply be required to document their procedures for making reasonable estimates but their methodology should be available to members upon request. Ideally this information could be made available through the fund's website.

Over-the-counter derivatives

B1 Q6 Do you consider the guidance and examples sufficient to understand the appropriate treatment of buy/sell spreads of OTC derivatives for superannuation and managed investment products?

It is important to capture the true costs of OTC derivatives to avoid a situation where a fund can take out a swap arrangement that mirrors a more traditional arrangement in all other respects but it results in the disclosure of a lower fee or no fee. If this cost is generally embedded in a buy/sell spread, then the cost should be included in indirect costs or management costs.

Also, the rationale for excluding buy/sell spreads on over-the-counter derivatives for hedging purposes for managed investment products from management costs should be explained as this is not obvious. We understand it relates to the different definitions of indirect costs and management costs.



Also, Example 9 makes a distinction between buy/sell costs (included in indirect costs) and transaction costs associated with opening and closing the position (included in transaction costs). ASIC should provide much more detail (both in the definitions contained in the relevant clauses and in the examples) to define these two types of costs so that issuers know how they should treat each of their costs.

B1 Q7 Is the guidance provided sufficient to apply the definition of buy/sell spread of OTC derivatives when used for hedging purposes by a responsible entity of a managed investment product?

Refer to our response to B1 Q6.

Inclusion of additional voluntary information

B1Q9 Do you consider this guidance to be appropriate?

It is appropriate to limit the inclusion of additional voluntary information on the fee template to a small group of tightly defined circumstances, such as for a defined benefit fund. The danger of allowing additional information on the fee and costs template is that it may confuse members and detract from the consistent disclosure of funds in the fee template. Where a trustee believes that strict compliance with disclosure requirements may mislead or confuse members, an explanatory comment could be added below the fees and costs template.

The first situation where RG 97.63 allows additional voluntary information is where the “gross fees do not accurately reflect the cost of a product to the retail client” and in such circumstances, “a product issuer may also wish to include the net fee with a simple explanation”. We assume that ‘gross’ refers to the fees being ‘gross of income tax’, but this should be clearly stated. The ability for trustees to disclose the net fee in the fee template is at odds with RG 97.76 that states that the method of recovering the fee or the cost should not be included, the gross/net of income tax issue simply relates to the method used to recover the fund’s costs from the member. The gross of income tax fees that are disclosed in accordance with RG 97.101-102 will accurately reflect the cost to the member on the same basis as other funds. However, if ASIC does agree to allow this information in the fees and costs template it should only allow it in the ‘How and when paid’ column so that the ‘Amount’ column remains intact.

The second situation where additional information is allowed is to show the split between different types of indirect costs (i.e. administration and investment). Rather than allowing this as additional information, the **split between these two types of indirect costs should be mandated** (see “Other Issues” below). All other fees and costs are clearly separated into administration, investment and advice fees and costs. Indeed, when funds report to APRA they need to report each type of indirect cost separately. One of the goals of Stronger Super is to facilitate better comparisons between funds but the current practice of bundling up all indirect costs into one number is a backward step and should be reversed.



Performance fees

B1Q9 Do you consider this guidance to be appropriate?

This issue is quite unclear and needs much more work. The introductory note to the Performance Fee questions in the Feedback Paper states that “we have also provided guidance in RG 97 on the estimation of the maximum performance fee that needs to be included in the investment fee for the superannuation fund’s fee example”. Likewise, RG 97.109 refers to using the highest fee in the possible range of performance fees. But RG 97.55 refers to “a reasonable estimate of expected performance fees”. We suspect that ASIC’s intention is that a reasonable estimate should be used, so the clauses that seem to contradict this should be changed. But the question remains - how should issuers calculate a reasonable estimate of performance fees?

Almost all funds disclose the previous year’s performance fee as their reasonable estimate as they argue it is impossible to determine a better estimate until the actual performance for the period is known. RG 97.55 labels this an ‘incorrect practice’ and requires that trustees use ‘reasonable grounds’ to calculate the disclosed performance fee. But RG 97 provides no guidance on what ‘reasonable grounds’ means other than it ‘should be determined objectively in the light of all the circumstances’ and with reference to RG 170.24 that contains similar high level requirements. If ASIC expects that ‘reasonable grounds’ may involve the long-term expected average performance fee, it should make this explicit and provide guidelines on the assumptions to be used in such calculations to avoid a gaming of this fee. There have been some instances where funds have shown their expected average performance fee assuming all managers meet (but not beat) their objectives which generally means no performance fees are payable.

The proposed ‘reasonable grounds’ requirement, along with the warning that using the previous year’s performance fee is incorrect, will lead to a wide range of practices in how funds disclose performance fees, which contradicts the key goal of RG97 of consistent disclosure. Clearer guidance should be provided.

It is significant that RG 97.91 requires that the indirect costs shown in a PDS are the costs from the financial year before the PDS is issued. Indeed, in many cases some performance fees will be included in indirect costs which will lead to a conflict in how they should be determined – according to the rules for indirect costs (previous year) or performance fees (reasonable estimate). Also, given indirect costs are much more predictable than performance fees from year to year, it is unusual that ASIC requires the use of the previous year’s indirect costs (which are more amenable to a reasonable estimate) but a separate estimate for performance fees (which are much more unpredictable and much more difficult to estimate).

ASIC does have a point when it suggests that simply using the previous year’s performance fee, without any consideration of the likelihood of a similar fee in the current year, may be misleading. But a fund should at least be able to use the previous year’s performance fees as a starting point, and only when it is clear that this is not a reasonable estimate a fund should revise this fee and explain what it has done in its disclosure. Situations where this could occur may include when the previous year’s fee was inordinately high or low compared to other years or when accrued performance fees for the year to date have been quite different to the previous year, indicating that the performance fees at the end of the year are likely to be quite different to the previous year.



We recommend that the guidance on performance fees allow that the 'reasonable estimate' be based on the previous 12-month period in which they were paid, but adjusted to reflect where more recent information suggests the fee is not indicative of expected annual costs in the medium term. Another approach would be to base performance fees on the average fee paid over the last three years, unless there has been a significant change in the way the option has been invested over that time. On the other hand, if ASIC decides that long-term estimates of performance fees is the best way to arrive at 'reasonable estimates', it would be important to specify the appropriate criteria to follow when setting the assumptions to use in these calculations.

B1Q10 Are there scenarios that you consider it would be appropriate to give further guidance on?

The disclosure of performance fees is a very important component of disclosure as the fees can vary significantly between funds. Therefore, performance fees warrant a much more comprehensive treatment than is currently included in the draft RG 97. Examples should be provided to illustrate what is expected in different situations. And there should be clear guidance on the circumstances in which the previous year's fee may be a reasonable estimate and when an adjustment should be made. If this is not done, the performance fees disclosed by funds will not be comparable.

Further guidance should also be provided on what performance fees should be shown for new products for which no performance fee has ever been paid. In such cases, funds should be allowed to use the performance fees for similar products as a starting point, adjusted to reflect the difference between the new product and the older product. Where there is no similar product, funds should be required to calculate the likely long-term performance fees payable assuming a reasonable level of outperformance, rather than disclose a Nil fee which is currently done by some funds.

Insurance Disclosure

B1Q11 Do you consider this guidance to be appropriate?

It is appropriate for RG 97 to address insurance disclosure as it is one area where the consistency of superannuation product disclosure needs to be improved significantly. Unlike fee disclosure, there is no template to ensure that premiums are disclosed in a consistent and comparable way. The insurance items included in RG 97 ensure that funds disclose components of premiums that are often not disclosed (eg. policy fees, monthly loading factors). Further guidance than what is provided in RG 97 would be warranted (see B1 Q12).

B1Q12 Do you recommend any other guidance that should be included to further assist industry in this area?

Just as some funds show fees net of tax, some funds show premiums net of income tax (and indeed some have changed from gross to net in recent years to appear lower cost), so ASIC should require that premiums, like fees, are shown gross of income tax.



Some funds show premiums by current age and others by age next birthday. Given disclosure documents are designed to inform members of the features and costs of their product in a comparable way to other products, premiums should all be shown by current age (i.e. age last birthday). RG 97.114 suggests that industry should decide on which age to use, but the better test is what is better understood by members and surely this is current age.

A number of funds have recently moved some of their administration costs that relate to insurance into their insurance premiums, in order to reduce the disclosed administration fees and costs. This is often expressed as a % of premiums and should be clearly disclosed by each fund.

Other Issues

Separate administration and investment indirect costs

Currently funds are required to disclose indirect costs (including both administration and investment costs) as one number in the fees and costs template (Schedule 10 of the Corporations Regulations 2001). RG 97 (and Schedule 10) should require that indirect costs for administration and investment be disclosed separately. Separating these two costs would be consistent with APRA's Reporting Standards (eg. SRS 702.0) which separates these two types of indirect costs.

It would also greatly assist members for whom the vague concept of an indirect cost is meaningless as it begs the question – 'what is this cost for?'

Clearer guidance on investment fees vs indirect costs (investments)

RG 97.100(b) addresses investment fees but provides no help to funds that are struggling to determine which of their standard investment expenses should be included as investment fees and which should be indirect costs.

Funds with very similar investment structures are currently disclosing investment expenses in very different ways, with some funds only showing investment fees, others only indirect costs and others a bit of both. While the aggregate of investment fees and investment-related indirect costs is what really matters, the wide variety in how these items are disclosed is very confusing (and potentially misleading) for members, especially if their fund discloses an Indirect Cost Ratio but no Investment Fee. There should be much clearer guidance to ensure that funds show the types of investment costs common to all funds, such as investment manager charges and the cost of the internal investment team (where these costs impact on member returns), under 'Investment fees'. Only true indirect costs such as the cost of underlying managers should appear in indirect costs.

Fees and costs must be shown gross of income tax

While APRA's Reporting Standard SRS 702.0 stipulates that fees and costs must be 'gross of tax obligations', there is no definition of this term and therefore about one third of not-for-profit funds continue to disclose administration fees and costs net of income tax obligations. They do this on the grounds that it is not fees that attract a tax deduction, but rather a fund's expenses that attract a tax deduction. If a fund chooses not to pass administration fees through its tax account, then its net-of-income tax fees are also its gross-of-income tax fees and this is what is disclosed. Some MySuper products recently



changed their fee disclosure from 'gross-of-income tax' to 'net-of-income tax', for the sole purpose of making their fees appear more competitive. Most funds however, disclose a gross-of-income tax fee and the member receives the benefit of the tax deduction relating to this fee, either by the deduction of a lower fee than is disclosed or by a reduction in tax on contributions.

As part of our submission to APRA's Discussion Paper on Reporting Standards for Select Investment Options, we included a detailed proposal that sets out how this issue should be addressed in its Reporting Standards. Our proposed definition of 'gross of income tax' is shown below. This should also be incorporated into Schedule 10. Clearly, due to the operation of Section 29QC of the *Superannuation Industry (Supervision) Act 1993*, it is important that treatment of this issue and the relevant definitions are consistent between APRA and ASIC.

While RG 97.102 and Example 14 go some way to addressing this issue, we believe a clear definition of 'gross of income tax' is required. We suggest the following definition for 'gross of income tax':

"A fee or cost that is gross of income tax is a fee or cost before adjustment for the income tax deduction the trustee may be able to claim against expenses that relate to the member. For example,

- (a) if a gross of income tax fee of \$100 is charged to the member's account and the tax on contributions is reduced by \$15, the amount the trustee must disclose is \$100, rather than \$85 which is the net cost to the member after allowing for the tax deduction (assuming the fund's income tax of 15%), or
- (b) if a net of income tax fee of \$85 is charged to the member's account and tax on contributions is not adjusted for the tax deduction in respect of the expenses relating to this fee, a gross of income tax fee of \$100 must be reported.

Any benefit of an income tax deduction relating to a fee or cost can be passed on to the member through the deduction of a lower fee or cost than is disclosed or as lower tax on contributions or income."

This definition should also be included in Schedule 10 so that the various disclosure requirements from both ASIC and APRA are consistent.

Further comments

In addition to addressing the questions above, we also suggest that the following issues be addressed in the final version of RG 97.

- RG 97.58 requires a separate fees and costs template for each MySuper product and Choice product. This is not necessary as all non-investment fees (i.e. administration, advice, withdrawal, switching etc.) will be the same for all options (except for a handful of cases across all products). Rather, there should be a requirement for a fees and costs template for each administration fee regime (eg. MySuper, Choice) with a separate table showing the investment fees and investment indirect costs (or, better still, just the aggregate "investment fees and costs") that relate to each option. **Including a separate 'total cost' template for every option will make disclosure unworkable and cumbersome for the members of many funds, which is not in the interests of members.**



- RG 97.91 requires that the indirect costs from the previous year be disclosed, except where current or prospective cost information is available. This is a sensible regime and a similar approach could be used for performance fees.
- RG 97.99 helpfully clarifies that indirect costs include the costs of deriving the return, either from the investment fund itself or before it is received from the fund. However, the clauses relating to indirect costs (RG 97.96-100) do not envisage administration indirect costs where they are not the cost of deriving the return but rather the cost of providing administration services, the trustee office etc.. The commentary on indirect costs needs to cover this type of indirect cost
- RG 97.100(b) specifies that fees include investment fees that are charged as a reduction in unit price, but since many not-for-profit funds use crediting rates rather than unit prices, 'or crediting rate' should be added after 'unit price' in this sub-clause
- We do not agree with the inclusion of amounts to build up the operational risk financial reserve (ORFR) requirement in indirect costs (RG 97.99 and RG 97.149). Indeed these two paragraphs are inconsistent with RG 97.148 and RG 97.150. For the many reasons explained in our letters of 5 March 2012, 20 December 2013, 23 October 2014 and 18 December 2014, we do not believe that any transfers to reserves are costs which reduce member "returns" (which is the premise of draft RG 97.99).
- The last sentence of RG 97.150, relating to "pure defined benefit super funds", is incomplete.

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Please do not hesitate to contact the Chief Executive Officer of the Actuaries Institute, David Bell (phone 02 9239 6106 or email david.bell@actuaries.asn.au) to discuss any aspect of this submission.

Yours sincerely

Estelle Pearson
President

cc **Tim Goodland**
Insurance and Superannuation Unit
Financial System and Services Division
The Treasury, Langton Crescent, Parkes ACT 2600
timothy.goodland@treasury.gov.au

Helen Rowell, APRA Member
Australian Prudential Regulation Authority
helen.rowell@apra.gov.au

Pauline Vamos, Chief Executive Officer
Association of Superannuation Funds of Australia
pvamos@superannuation.asn.au