FSC FINANCIAL SERVICES COUNCIL

4 September 2015

Mr Maan Beydoun
Senior Specialist
Investment Managers and Superannuation
Australian Securities and Investments Commission

By email only (to Maan Beydoun)

Dear Maan

FSC comments on the 22 July 2015 draft of ASIC's Fee and Cost Class Order Amendment and draft Regulatory Guide 97 *Disclosing fees and costs in PDSs and periodic statements*

1. We thank ASIC for providing FSC with the opportunity to comment on the 22 July 2015 draft amendment (the **Class Order Amendment**) to Class Order 14/1252 on fees and costs and the draft Regulatory Guide 97 *Disclosing fees and costs in PDSs and periodic statements* (**Draft RG 97**).

2. We refer to our prior submissions on this subject matter including our submissions dated 26 August 2014, 22 October 2014, 2 March 2015, and 7 May 2015. Many of our substantive comments have not been taken up in the Class Order Amendment and Draft RG 97.

3. Our members find many aspects of the Class Order and Amendment difficult to understand, and complex. Given our membership includes experienced issuers and major law firms, this is a fair barometer of the lack of clarity in many aspects of the Class Order.

4. Our submission is in **three parts**, namely:

   (a) **Executive Summary – Essential changes** containing what is in the view of the FSC membership the absolute minimum changes or issues to be addressed which ASIC would need to make to the Class Order (and RG 97) for the Class Order to be potentially workable. Without these changes, ASIC's Class Order will remain problematic and unworkable. (We stress these are not the only changes we consider need to be made to the Class Order, which are set out in later sections of this submission).

   (b) **Thematic Comments** – setting out our broad comments on the Class Order and Draft RG 97.

   (c) **Detailed and/or Technical Comments** – containing more detailed and technical (albeit still important) comments and changes we seek.

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5. ASIC Class Order 14/1252 was issued in December 2014 and the latest draft of the Class Order amendment was issued 22 July 2015. Even though ASIC has provided further time to consider the 22 July 2015 draft, our members may have further comments, and we reserve the right to make further comment (a reservation required due to the complexity of the Class Order, the finite time to submit to this submission and the large number of comments received from our membership in response to this consultation).

We look forward to discussing the draft Class Order Amendment and RG 97 at the ASIC hosted industry round table on 9 September 2015 which we welcome, with a view to obtaining a workable outcome for the final Class Order and RG 97.

Yours sincerely

Stephen Judge
General Counsel

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Part 1: Executive Summary – Essential Changes

Clarification of 'interposed vehicle'

6. The Class Order should contain a simple, principles-based definition. The current definition is far too complex.

7. Assuming ASIC does not make substantive changes to the draft Class Order amendment (this submission requests substantive changes), then Regulatory Guide should contain further details, including ASIC's flow chart and various examples.

Fees – general

8. The fees and costs disclosed in the *fee template* must align with those used in the *fee example*. The concept of '*currently applying*' for the fee template and '*typical ongoing*' for the fee example goes totally against the intended purpose of the *fee example* (i.e. to illustrate the total dollar cost impact of the fees and costs disclosed in the *fee template* and facilitate comparison) and would be extremely confusing for investors.

Indirect costs

9. Issuers should **not** be restricted to using historical indirect costs (i.e. previous financial year's actuals) only. This is a logical starting point but there **must** be scope for indirect costs to be based on more current (i.e. forward looking) costs where they are likely to differ from historical costs (e.g. an abnormal cost incurred in a particular year would, by its very nature, not be representative of typical costs in future years), as currently provided for in RG 97.83 of the existing (i.e. November 2011) RG 97. Without this ability, an issuer's PDS could potentially be misleading.

10. Issuers also need the ability to separately identify/disclose any *components* of indirect costs rather than just disclose a *bundled* total. This is particularly relevant to provide greater transparency where an individual *component* may account for a significant portion of the total indirect costs and/or total management costs (e.g. performance fees).

Performance fees

11. Issuers **must** be able to estimate performance fees in all cases, irrespective of whether they are payable directly to the trustee/responsible entity or incurred indirectly in *interposed vehicles*. Without this ability, an issuer's PDS could potentially be misleading.

12. Issuers **should** also be able to separately identify/disclose and use the term 'performance fee' when it is incurred indirectly in an *interposed vehicle* as long as it is clear that the amount forms part of the indirect cost and is not charged as a direct fee (e.g. itemised as a 'performance fee' within an overall 'indirect costs' category).

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Updating PDSs

13. It is unrealistic and prohibitively expensive (hence, potentially generating additional costs to investors) for issuers to be continually replacing PDSs (e.g. where the actual indirect costs differs from the estimate provided in the PDS). However, this issue could be largely and easily resolved if issuers were not compelled to base/estimate indirect costs solely on the previous (i.e. historic) financial year's actual indirect costs (refer to 'Indirect costs' above).

14. Industry does not share ASIC's view that shorter PDSs may not avail of the Up to Date Class Order. Also, industry does act on and uses the Up to Date Class order for Shorter PDSs. To the extent ASIC considers shorter PDSs cannot avail of that Class Order ASIC needs to either remove the restriction specifically preventing the updating of shorter PDSs via website or provide its reasoning behind this restriction.

Materiality of drill-down to estimate costs through *interposed vehicles*

15. The Class Order requires drill-down through *interposed vehicles* to obtain estimates of costs, being costs not actually known to the issuer. There should be a point beyond which issuers are not required to incur inordinate time and expense to estimate a cost in an interposed vehicle where the issuer reasonably considers such a cost is likely to be insignificant or not material.

Derivatives

16. Our members have concerns in relation to the implications of ASICs requirements in relation to estimating the cost of derivatives. Further detail is contained in this submission.

Transition period

17. ASIC should accept that there will be a mix of up to three differing scenarios during the transition period (i.e. 1. Compliance with existing Corporations Act/Regulations and RG 97 (November 2011); 2. Compliance with 1 as amended by original CO 14/1252; 3. Compliance with 1 and/or 2 as amended by amending CO 14/1252 and the updated RG 97).

18. Regardless of the date(s) set by ASIC by which all PDSs and periodic statements must comply with the final disclosure requirements, issuers should not have to state in a PDS or periodic statement that it complies with any particular disclosure requirement or Class Order.

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Part 2: Thematic Comments

19. Given the complexity and relatively limited time to comment on complex documents, we set out some thematic comments on the draft Class Order Amendment and Draft RG 97. Our more detailed comments for *some* of our thematic comments follow in Part 3 "Detailed and Technical Comments" section of this submission.

Class Order complexity

20. The Class Order amendment drafting is complex and convoluted (as is existing CO 14/1252). Across FSC's membership we struggled to cut-through the application and meaning. We do not consider it an answer to suggest the meaning is clarified in RG 97 (in some cases that may be the case) as it is the law (i.e. the Class Order) which needs to provide a clear meaning on its drafting and our members consider the Class Order – broadly speaking – unnecessarily complex.

Transition period

21. The amended Class Order will impact on existing PDSs, new PDSs and periodic statements. We request that the transition period be as follows:

    (a) **All PDSs** (whether currently on issue, or not yet issued) must comply with the amended Class Order by 1 October 2017 (assuming the RG and Class Order amendment is finalised late 2015 and assuming ASIC retains its current requirement around use of historic financial year figures).

        (i) Shorter transition periods are problematic as entities plan rolls around different periods or months. A 1 October 2017 transition date would allow issuers to use historic figures for the year ending 30 June 2017 (we however note later in our submission the unintended consequences with use of historic figures in all cases). We note that issuers with financial years ending on 30 June will have difficulty with a 1 July (2017) start date since determining indirect costs will be difficult where those are calculated based on the previous financial year and the previous financial year's historic information (for the year ended 30 June 2017) is not available until September/October 2017.

    (b) For **periodic statements** we request the following transition arrangements:

        (i) Periodic statements (except exit statements) for a *reporting period* commencing on or after 1 July 2017 must comply with the amended Class Order;

        (ii) Periodic statements which are exit statements (i.e. issued under s 1017D(2(d) Corporations Act) *issued on or after* 1 January 2018 must comply with the amended Class Order.

22. ASIC has already issued CO 14/1252 and will be amending it. Some issuers will have already updated PDSs for CO 14/1252 (unamended) and some will not yet have done so (given the 1 January 2016 transition date for PDSs under CO 14/1252). Issuers should be able to transition to the post amendment Class Order regime by the 1 October 2017 PDS transition date above, and not be required to update PDSs for the unamended CO 14/1252 in the interim. That is, *during the transition period* for the Class Order amendment, issuers should be able to comply with the law by adopting any of the:

    (A) pre-December 2014 CO 14/1252 regime;

    (B) the-post December 2014 CO 14/1252 regime (but before the proposed amendment to that CO); or

    (C) the post-amended CO 14/1252 regime (after amendment of CO 14/1252).

    Further issuers should be able to transition PDSs to the post amended CO 14/1252 regime *at any time on or prior to 1 October 2017*.

23. Issuers should not have to state in a PDS or periodic statement that it complies with any particular disclosure requirement or Class Order and ASIC should accept that there will be a mix of up to three differing scenarios *during the transition period* for the post Class Order amendment regime for which compliance should be acceptable (given ASIC is amending the regime):

    (a) Compliance with existing Corporations Act/Regulations (prior to amendment by CO 14/1252 issued December 2014) and existing RG 97 (November 2011);

    (b) Compliance with (a) as amended by the December 2014 CO 14/1252; and

    (c) Compliance with (b) as further amended by the proposed Class Order amendment to CO 14/1252 and any amendments contained the updated RG 97 being consulted on). Including a statement (as required by the note to Draft RG 000.6 and in current CO 14/1252 paragraphs 8(b) and 9(b)) in a PDS or periodic statement that the PDS or periodic statement complies with a Class Order is meaningless to investors.

Different treatment of superannuation and MIS

24. The different treatment of superannuation and managed investments (**MIS**) is concerning and is already leading to inconsistency and confusion – ASIC's class order is driving the difference in part (e.g. derivatives). We refer ASIC to our prior submissions (including our 7 May 2015 and 2 March 2015 submissions). Given superannuation funds invest in MIS, MIS managers will by default be required to seek to calculate in accordance with, and be subject to (indirectly), superannuation requirements. **The hedge treatment for OTC derivatives for MIS**

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should also apply to superannuation (if ASIC retains the requirement for estimating costs of OTC derivatives which this submission provides comment on).

Materiality threshold for disclosure

25. Materiality is of two types:

    (a) Whether a fee/cost needs to be estimated at all because it is below a specified threshold in light of the costs or difficulty of seeking to estimate such fee/cost; and

    (b) Where a fee/cost is above the threshold and is disclosed, where only material changes to such costs need to be further disclosed in continuous disclosure or in a revised PDS. A guide on a materiality threshold for such changes should be specified, particularly where the actual costs increase from the (estimated) ICR/management cost. For example, it may be appropriate for a materiality threshold (in relation to disclosure) similar to accounting standards. That is where actual costs turn out to be higher than the estimate by less than the accounting materiality threshold, then further disclosure should not be required. (It may be that where actual costs turn out to be less than estimated costs, it is not necessary for further disclosure.) We request the accounting materiality test (less than 5% of costs is not material, greater than 10% of costs is material, and matters between this range require further assessment).

    For example, where a fund has only a small exposure to OTC derivatives do these indirect costs need to be sought to be estimated and then included in the ICR/Management Cost (bearing in mind the cost of estimation of what is – after all – an estimate)?

26. Given the difficulty and time and cost in estimating some costs, there should be a materiality provision to clarify the *reasonable estimate* test.. For example, if the potentially identified costs were not likely to be more than 5% of total costs to the member, then issuers should not be required to incur costs and time *estimating* such a cost. As noted in our 2 March 2015 submission, there should be some materiality threshold in light of ASIC's "reasonable estimate" test in relation to costs which are not (by definition) actually known to the trustee or responsible entity.

27. Given the uncertainties with providing for estimates of fees and costs, which could change during the period in which a PDS is on issue, it would be of assistance to industry for a materiality threshold to be set to avoid unnecessary rolling of PDSs. This threshold could be based around the existing Class Order relief (03/237) for issuers which allows them to update on their website disclosure changes which are not materially adverse.

28. This point goes to the practicalities as it goes to the cost of implementing ASIC's prescriptive fee and cost regime, including the on-going costs of compliance (see our comment below in relation to our concern with the absence of an RIS).

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Updating PDSs and the Up to Date Class Order (CO 03/237)

29. It is both unrealistic and expensive (hence, potentially additional costs to investors) for issuers to be continually replacing PDSs (e.g. early in each financial year to reflect the previous year's *actual* indirect costs where the *actual* differs from the *estimate* in the PDS – as would be the norm given the estimate is an estimate).

30. Issuers should be able to determine whether or not a variation in actual costs from the estimate in an ICR/management cost is materially adverse and would require a PDS to be updated.

31. In the Draft RG 97 ASIC notes that the "Up to Date" Class Order 03/237 is not available for the (8 page) shorter PDS regime. This is not a commonly held industry view. The Up to Date Class Order is available for the shorter PDS regime and many in industry use the "Up to Date" Class Order 03/237 for updating Shorter PDSs. ASIC should either remove its statement preventing the updating of shorter PDSs via website disclosure (i.e. under CO 03/237) or engage with industry to discuss ASIC's view and industry's view. To the extent ASIC does not change its view then industry requests ASIC to urgently clarify the Up to Date Class Order to accommodate industry's interpretation (and use) of the Up to Date Class Order for shorter PDSs. (For completeness, we are aware that Shorter PDSs are excluded from the supplementary PDS regime, but that there is a form of IBR for Shorter PDSs).

32. ASIC has noted that the law facilitates updating incorporated disclosures (IBR) while not updating an 8 page short PDS. However, since fees and costs disclosure is a mandated section for short PDSs, it is highly unlikely that it would be possible to update fees and costs in only the relevant IBR document. Consequently, once the need arises to update a short PDS, then all IBR documents (including any others that have nothing to do with fees and costs disclosure) would also need to be replaced since IBR documents have to clearly identity the PDS they form part of (e.g. by reference to the replacement PDS issue date). In effect, therefore, the provision noted by ASIC provides no comfort in these circumstances.

Clarification of 'interposed vehicle'

33. The Class Order should contain a simple, principles-based definition of *interposed vehicle*. The current draft definition of "interposed vehicle" is convoluted and complex, and it is unclear in its approach from a policy perspective e.g. it is inconsistent in its treatment of listed and unlisted entities.

34. RG 97 should contain further details plus various examples (including the two additional examples in this submission at paragraph 72) to illustrate the concept of '*having regard to the Product Disclosure Statement*'.

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35. Infinite look through of interposed vehicles will be onerous, and in some cases impossible, to comply with. The costs of looking through multiple layers of interposed vehicles will be costly for issuers and will produce minimal additional information for investors.

36. An alternative approach in relation to the definition of *interposed vehicle* is that ASIC draft a much shorter and easier to understand definition of *interposed vehicle*, and supplement its expectations in its guidance (RG 97) after consultation of course. Updating the RG is much easier for ASIC than re-engaging on refinements to a highly complex Class Order. Having a simple principles-based definition of *interposed vehicle* in the Class Order with supporting detail in RG 97 would give ASIC much more flexibility to add or change, with consultation, the RG as new types of *interposed vehicles* potentially evolve. For example, a starting point for a principles based definition of ***interposed vehicle*** is:

    any entity (including, but not limited to, a security, body, partnership or trust) that provides the means by which the product or option gains exposure to the underlying assets in which the product or option ultimately invests, having regard to the Product Disclosure Statement for the product or option.

    See paragraph 72 for more information and two examples for inclusion in RG 97.

Fees – general

37. (**Historical v forward looking fee & cost disclosure**) Draft RG 97 states that issuers should use "typical" fees and charges in the PDS *worked example* and that these amounts may therefore differ from those set out in the fee and cost *template* (RG 000.88). This difference is largely attributable to the guidance separately requiring that indirect costs should be disclosed in the fee template "based on the costs incurred during the ***previous*** financial year" (RG 000.24). This inconsistency is likely to be confusing and issuers should be able to take into account current/forward looking considerations if disclosure of the previous year's figures risk being misleading.

38. The fees and costs disclosed in the *fee template* must align with those used in the *fee example*. The concept of 'currently applying' for the *fee template* and 'typical ongoing' for the f*ee example* goes against the intended purpose of the *fee example* (i.e. to illustrate the total dollar cost impact of the fees and costs disclosed in the *fee template* and facilitate comparison) and would be extremely confusing for investors.

39. There should be exceptions from the requirement to use *previous* financial year information for indirect costs where this would be misleading and deceptive. We suggest that the amending CO (in relation to Schedule 10 subclause 104(2)) allow a reasonable estimate of future indirect costs to be used where to use the previous year's costs would, in the product issuer's reasonable opinion, make or potentially make the PDS misleading and deceptive and/or have no relevance to the future indirect costs of the product. More generally, disclosure of fees and costs in PDSs should reflect what an investor is likely to pay on a 'go

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forward basis'. The member/periodic statements are then used to report historical costs and will capture and inform investors of previous financial year indirect cost information.

40. The different temporal basis for calculating fees and indirect costs is likely to lead to confusion for investors. Fees are to be disclosed on a "current" basis, whereas indirect costs are to be disclosed on a historical basis (even where the issuer knows the historical information is misleading). This different basis is undesirable, particularly as the fees and indirect costs will be disclosed alongside each other in the same tables and examples.

41. (**Super – "amounts not paid out of a superannuation entity"**) The amendment to the definition of "investment fee" for superannuation to exclude "amounts that are not paid out of a superannuation entity" requires additional explanation to ensure it is applied consistently across the industry. This is a key issue for comparability. Also see RG 000.122. Our members were unsure what is meant by "amounts that are not paid out of a superannuation entity" and we ask ASIC to provide clarification.

42. (**Maximum Fees**) Draft RG 97 states that fees must be disclosed on the basis of the maximum permitted under the constitution or trust deed (or another binding arrangement). This change would have substantial 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 precisely specify the fees currently applicable to particular members. This is sufficient to ensure members only pay those fees which have been disclosed to them. Changes to fees are dealt with through the conventional significant event notice process. This change would lead to disclosures that are less reflective of the fees investors will actually pay.

Performance fees

43. Issuers must be able to *estimate* performance fees in all cases, irrespective of whether they are payable directly to the trustee/responsible entity or incurred indirectly in interposed vehicles. Without this ability, an issuer's PDS could potentially be misleading. We have provided a performance fee example in paragraph 72 to illustrate where applying ASIC's approach may give rise to potentially misleading disclosures. Issuers have been including estimated performance fees in PDSs for a significant amount of time. We are not sure of the issues with current practices in estimating performance fees, or what is remedied by being unduly prescriptive in relation to how issuers must estimate performance fees. Provided issuers provide a reasonable estimate taking into account all relevant factors, this should be acceptable.

44. (**Performance fee in interposed vehicles**) Issuers should also be able to identify separately and use the term 'performance fee' when it is incurred indirectly in an *interposed vehicle* as long as it is clear that the amount forms part of the *indirect cost* and is not charged as a direct fee (e.g. itemised as a 'performance fee' within an overall 'indirect costs' category). Regardless of whether charged directly (i.e. payable to the trustee or responsible entity) or incurred indirectly in interposed vehicles, performance fees can have a significant impact on total

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management costs presented, and issuers need to be able to show that a seemingly high total management cost could be largely attributable to the (estimated) performance fee component.

45. Below is an example to illustrate that issuers should also be able to identify separately and use the term "performance fee" when it is incurred indirectly in an *interposed vehicle*, so long as it is clear that the amount forms part of the indirect cost and is not charged as a direct fee:

Better form of disclosure

Table 1

INVESTMENT FUND	MANAGEMENT FEE (% PA)	ESTIMATED INDIRECT COSTS (% PA)		TOTAL ESTIMATED MANAGEMENT COST (% PA)
		ESTIMATED PERFORMANCE FEES	ESTIMATED OTHER INDIRECT COSTS	
Balanced	1.00%	3.50%	0.50%	5.00%

Less effective form of disclosure

If issuers are not able to identify separately and use the term "performance fee" when it is incurred indirectly in an *interposed vehicle*, issuers would potentially end up with the following disclosure in Table 2 instead, which is less effective than the disclosure in Table 1 immediately above.

Table 2

INVESTMENT FUND	MANAGEMENT FEE (% PA)	ESTIMATED INDIRECT COSTS (% PA)	TOTAL ESTIMATED MANAGEMENT COST (% PA)
Balanced	1.00%	4.00%	5.00%

46. In the Table 2 case, *the reason why the management cost seems very high* (i.e. due to the high performance fee estimate - which is likely to mean a good investment outcome, if achieved) *would not be apparent to the investor*. This is ineffective disclosure. Our proposal (see Table 1) would also make it quite clear that the actual management cost would only be 1.50% if the performance fee criteria were not met.

47. We think ASIC is unduly prescriptive in suggesting it will often be the case that an estimate of future performance fees should usually be based on past performance fees and that another

basis of estimating future performance fees will "often be unreasonable". With due respect, we do not understand the reasons for ASIC's generic statements when, it will depend on the circumstances surrounding the past period which will bear on whether the past could reasonably be extrapolated (or not) to the future, for the purposes of estimating the future performance fee. A generic statement that estimating performance fee other than on the past performance fee is "usually unreasonable" is unfounded. We are agnostic as to whether performance fee estimates are on the past performance or not, as what is relevant is whether it is a reasonable position (or not) to use past performance in estimating future performance fees. We can contemplate situations (e.g. stellar performance) where using past performance to estimate future performance may be less appropriate; or conversely where no out-performance in the past two years may not be appropriate to use as the basis to suggest it is unlikely there could be a performance fee in the next period.

48. Further in relation to RG 000.86 ASIC note that an estimate of performance fee may be used for an investment fee but not for performance fees in interposed vehicles. This is inconsistent. See our comments above.

Indirect costs

49. Issuers should not be restricted to using historical indirect costs (i.e. previous financial year's actuals) only. Historical indirect costs are a logical starting point but there **must** be scope for indirect costs to be based on current (i.e. forward looking) costs where they are likely to differ from historical costs (e.g. an abnormal cost incurred in a particular year would, by its very nature, not be representative of typical costs in future years), as currently provided for in paragraph RG 97.83 of the existing (i.e. November 2011) RG 97. Without this ability, an issuer's PDS could potentially be misleading if historical indirect costs are applied in every case (particularly where the past is not a reasonable representation of what may occur in the future). This is implicitly acknowledged by ASIC in paragraph RG 97.83 of the existing (November 2011) RG 97.

50. Issuers also need the ability to separately identify any *components of indirect costs* rather than just disclose a *bundled* total. This is particularly relevant to provide greater transparency where an individual component may account for a significant portion of the total indirect costs and/or total management costs (e.g. performance fees), as illustrated by the examples in Tables 1 and 2 of paragraph 45.

Derivatives

51. FSC acknowledges that ASIC has revised the definition of OTC derivatives costs and, in particular, ASIC has removed the "buy-sell spread" terminology from the Class Order (although noting that for derivatives that are "options", the cost description is in effect referring to the "buy-sell spread"). As noted in our prior submissions (including our submissions dated 2 March 2015 and 7 May 2015), it was not clear why the buy-sell spread for any OTC derivatives should be treated as indirect costs rather than transactional or operational costs. In any event, the inclusion of "costs" of OTC derivatives as indirect costs/management costs continues to

pose significant concerns to FSC members, both from a policy perspective and from the perspective of the regulatory burden ASIC's approach will cause in relation to monitoring FSC reiterates its previous submission to ASIC that to the extent ASIC is concerned about use of derivatives to "hide costs", then ASIC should adopt an anti-avoidance test, rather than imposing a compliance burden on all REs/trustees to monitor OTC derivative costs.

52. ASIC's class order amendment imposes a significant regulatory burden on issuers in requiring issuers to monitor changes in (unrealised) differences in the implied cost of the derivative – even if that cost is not incurred if the derivative is held to expiry. For certain types of derivatives, estimating these costs will be onerous, and in some cases impossible, to comply with, requiring entities to obtain large volumes of information which is not currently readily available. In any case, for many derivative types, ASIC's definition will not reflect the cost of the derivative (as the value of the derivative may not be directly correlated to the "reference asset").

53. We are aware that IOSCO recently issued a **consultation report** (linked **here**) on fees and expenses of investment funds. The report addresses fee and costs disclosure. In the report, IOSCO recognises the difficulty in calculating transaction costs such as buy/sell spreads and that it may be difficult for managers to obtain specific information from counterparties about implicit costs.

54. It is not clear what costs are to be included in indirect costs relating to OTC derivatives – we seek more clarity in RG 97. In particular, it should be clarified in RG 97 that brokerage and other transaction costs of managed investment schemes are not management costs, regardless of whether the OTC derivative is used for hedging purposes (as otherwise suggested by RG 000.75). Brokerage is also expressly excluded from the management costs definition under the Regulations and RG 97 should be consistent with this.

55. Also the exemption for managed investment schemes for OTC derivatives used for hedging purposes (on the basis that these costs fall within transaction costs and are excluded from the calculation of management costs) creates inconsistency, given that any managed investment schemes that hold superannuation monies will in any event be required to report this information to the superannuation trustee so the superannuation trustee/s can comply with their (superannuation) disclosure obligations under the Class Order. Therefore the exemption of hedge OTC derivatives should be extended to superannuation as well as managed investment schemes.

56. The requirement to estimate and disclose OTC derivatives costs as indirect costs continues to raise a number of concerns. These concerns include the potential costs and time involved with quantifying, and ongoing monitoring, of OTC derivative costs against amounts disclosed in the PDS and the application of these definitions to different derivative structures. The ambiguity around these "costs" will make it extremely difficult for managers to report indirect costs in a similar fashion across the industry, which will lead to differing levels of fees reported and

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therefore more confusion. The initial assessment and ongoing review will also be time consuming and costly to apply.

57. Given the difficulty in estimating some of these costs, there should be a materiality provision to clarify the reasonable estimate test (if ASIC maintains its position on OTC derivatives). For example, if the potentially identified costs were not likely to be more than 5% of total costs to the member, then issuers should not be required to incur costs and time estimating such a cost. As noted in our 2 March 2015 submission, there should be some materiality threshold in light of ASIC's "reasonable estimate" test in relation to costs which are not (by definition) actually known to the trustee or responsible entity.

58. We also consider that there should be consistent treatment between exchange traded and centrally cleared derivatives, noting recent amendments to the ASX rules to define "OTC Derivatives". Under the ASX Rules, the definition of OTC Derivative excludes a derivative that is exchange traded or centrally cleared. We request that ASIC apply the same consistent treatment.

Superannuation – investing in a life policy

Life company structure vs. direct structure

59. A significant anomaly with the Regulatory Guide is the inconsistent disclosure outcomes of largely identical superannuation products depending on the investment structure of the superannuation fund. The anomaly will lead to a fee disclosure regime that is confusing for investors, and that significantly detracts from the aim of facilitating fee comparisons between products.

60. We believe that consumers would be better informed if it was open to a superannuation Trustee that invests via an interposed vehicle to apply a 'look through' approach to the disclosure of the fees that are charged at the interposed vehicle level where the superannuation trustee considers that would be a more appropriate or effective means of disclosure. *Some superannuation trustees will form the view that the current approach is appropriate, while others will consider that it is more effective to look through to the life company – either approach should be available for life backed superannuation policies*.

61. The Regulatory Guide should be amended to make this option (look through to the life policy fees and costs) available to the Superannuation Trustee provided that the Superannuation Trustee discloses the full quantum of the fees, and in applying the 'look through' approach adheres to the appropriate naming conventions when allocating the fees to categories so long as it is not misleading or deceptive to do so. This includes amending the various examples in proposed paragraph RG 000.59 to provide this alternative (in addition to the alternative of treating the fees at the life company level as an indirect cost).

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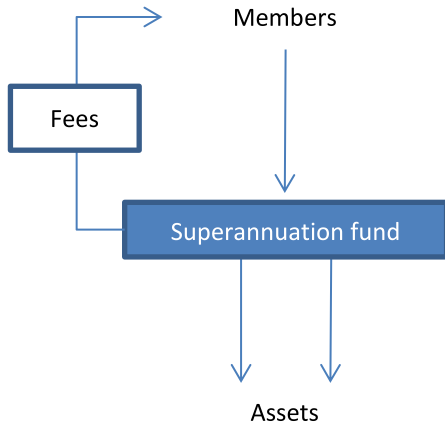
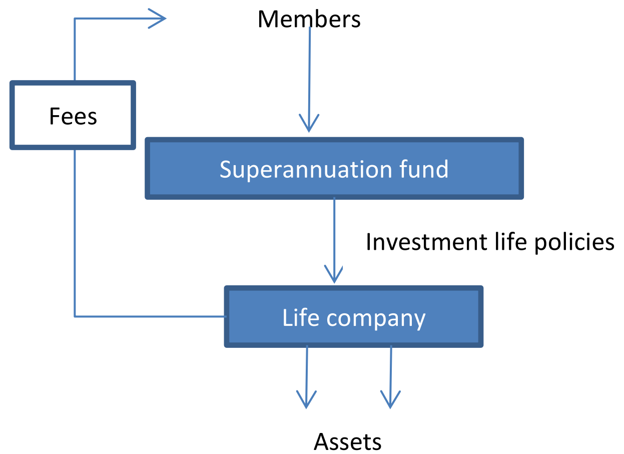
62. Below, we have compared two similar products under different structures, one where fees are charged directly and another superannuation product that is backed by a master life policy, where the fees are charged at the interposed vehicle level. The products of the two structures of separate superannuation funds can be demonstrated by the diagrams below. While Product A would disclose investment and administration fees separately, Product B would disclose the indirect costs ratio given it falls within the definition of an interposed entity.

Product A – direct structure



Product B – life company structure (exact same underlying asset pool as Product A)



	Product A (direct investing)	Product B (invests via a life company)
Type of fee	Amount	Amount
Investment fee	A%	Nil
Administration fee	$B	Nil
Indirect cost ratio	Nil	Z

Ratio of the total of the indirect costs for the product to the total average net assets of the super fund.

63. The fee disclosure outcomes of the two similar products under the two different structures can be further illustrated in the sample fee table above. Assuming both product A and B charge exactly identical dollar or percentage based fees for the administration fee and the investment fee, Product A would disclose the administration fee as $B and investment fee as A% in the fee table. However, due to the fact that Product B has a Life Company as an interposed vehicle, it will need to disclose both fees as an indirect cost ratio, Z.

64. The Class Order amendment changes the disclosure for life insurance backed investment structures (a fairly common structure for some superannuation funds). That is, there is a change from these costs being classified as *investment fees* to being classified as an *interposed vehicle* and treated as *indirect costs*.

65. To enable transparency & comparability, a superannuation fund should **have the option (but not be mandated)** to look-through the superannuation fund to the underlying life policy for the purposes of fee and cost disclosure (i.e. look-through to the fees shown as investment fees/administration fee at the life policy level rather than presenting it as an ICR at the

superannuation fund level). A similar option should be available to issuers for similar arrangements through interposed vehicles where it is not misleading to do so.

66. Similarly some superannuation funds using a Product B structure may consider it more appropriate to show the figures as a rolled up ICR at the superannuation fund level as we understand some superannuation funds do currently. This option should be retained so long as the superannuation fund considers it not misleading to do so.

Regulatory Impact Statement – significant costs arising from Class Order and Amendment

67. Class Order 14/1252 was not subject to a Regulatory Impact Statement as ASIC considered the Class Order to be minor and machinery (and this assessment was accepted by the Office of Best Practice Regulation). This is not a view held within industry – FSC is not aware of any FSC Member who considers the impact and complexity of the class order *minor or machinery* (as used by OBPR). We do not consider either CO 14/1252 or the draft amendment as minor or machinery. For example, the impact on industry of ASIC's amendment to the law in relation to derivatives costs imposes additional burdens (as well as changing the law in relation to managed investment schemes). A sample of indicative cost data which some FSC Members have provided to FSC in relation to the cost implications of ASIC's fee and cost class order is below:

a. **Member A** – has rolled some PDSs under CO 14/1252 – the costs to roll again the PDSs under the amendment are likely to be significant – likely to be well in excess of $1,000,000 – if Member A has to again replace the many PDSs that Member A has already reissued this year by 1 January 2016 for the original CO 14/1252, in order to comply with additional and/or altered requirements under the amending CO and updated RG 97.

b. **Member B** – The approximate cost of PDS rolls as a result of the further fee and cost changes is estimated to be in the region of $585,000.

c. **Member C** – Member C has estimated that ASIC's proposed changes will cost Member C in the region of $3,000,000 to implement.

d. **Member D** – Member D has in the region of 300 PDSs and the cost of rolling PDSs is in the region of $2.6 million. To the extent the Class Order (and/or amendment) necessitates a PDS roll initially or an ongoing basis, this is the region of costs noted by this member. It is observed that customers are likely to bear a portion of such costs.

68. Our research on *minor or machinery* indicates that OBPR considers *minor or machinery* as:

> The OBPR assesses whether the proposal requires a RIS or whether it is minor or machinery in nature and does not require one.

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- 'Minor' changes refer to those changes that do not substantially alter the existing regulatory arrangements for businesses or individuals, such as where there would be a very small initial one-off cost to business and no ongoing costs. Examples of minor changes include allowing entities to lodge applications electronically, and clarification of registration requirements or definitions.

- 'Machinery' changes refer to consequential changes in regulation that are required as a result of a substantive regulatory decision, and for which there is limited discretion available to the decision maker. Changes which are machinery in nature do not necessarily have a small impact. Examples of machinery changes include administrative changes such as name changes, updating thresholds, and changes to levy rates in line with movements in CPI.

69. We consider the Class Order (and the amendment) is not minor or machinery – the Class Order impacts on the costs of product rolls and requires monitoring in relation to interposed vehicles and the ongoing monitoring to estimate the (often unrealised) costs of derivatives.

70. Our members consider that a lot of the FSC feedback in prior submissions do not appear to have been addressed by ASIC, for example no materiality threshold or guidance as to how far issuers must drill-down on external costs/fees and at what point can issuers reasonably not drill down further in relation to external costs and fees. We refer to FSC's prior submissions. There will be a point at which the costs of further drill down exceed the benefit of any marginal increase in transparency.

71. Our more detailed comments on the draft Class Order Amendment and RG 97 are in the following pages (Part 3: Detailed and Technical Comments).

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Part 3: Detailed and Technical comments

Comments on Class Order – General Comments

Interposed vehicles

72. Below is a revised approach to *interposed vehicles* using a principles based test followed by (more flexible) ASIC Guidance in RG 97:

> "***Interposed vehicle*** is any entity (including, but not limited to, a security, body, partnership or trust) that provides the means by which the product or option gains exposure to the underlying assets in which the product or option ultimately invests, having regard to the Product Disclosure Statement for the product or option."
>
> **Regulatory Guide**
>
> The RG could then include the following examples to illustrate the concept of what is and isn't an interposed vehicle, together with as many other examples that ASIC may wish to include (which ASIC could also expand upon over time as the need arises) to illustrate other scenarios:
>
> **Example 1:** The PDS states that:
>
> - the investment objective of the product or option is to provide long-term capital growth and regular income through investment in quality Australian shares and to outperform the S&P/ASX 300 Accumulation Index (before fees and taxes) over rolling three-year periods
> - the product or option may gain its exposure to Australian shares by investing in assets directly or indirectly via listed investment companies (LIC), other managed investment schemes (MIS) and/or exchange traded funds (ETF) that have a consistent investment objective.
>
> In this case, each of the LIC, MIS and ETF **are interposed vehicles** because they merely provide the means by which the product or option gains exposure to the underlying Australian share assets (i.e. unlike any Australian shares held directly, the LIC, MIS and ETF themselves are not the underlying assets having regard to the PDS).
>
> **Example 2:** The PDS states that the investment objective of the product or option is to provide long-term capital growth and regular income by investing in a range of listed investment companies (LIC) and to outperform the S&P/ASX 300 Accumulation Index (before fees and taxes) over rolling three-year periods.
>
> In this case, the LICs **are not interposed vehicles** because, in the context of the PDS disclosure, they rather than the underlying shares which the LIC may ultimately hold are considered to be the assets in which the product or investment option invests.

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73. If ASIC retains its current drafting approach under the Class Order, our more detailed comments are below on the definition of *interposed vehicle*.

74. 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.

75. The concerns with the asset-based test include:

    a. It requires knowledge of the assets of each entity. This is very onerous and time consuming. Further, there is no guidance on what to do if the trustee does not have sufficient information (despite making reasonable enquiries) and cannot determine (or cannot determine to the point of reasonable endeavours), the assets of an entity.

    b. Assets are excluded from being counted towards the asset-based test if they are a means for investing in real property or they confer control over another entity. However, there are exclusions to these exclusions if the underlying entity satisfies the asset-based test. The exclusion from the exclusion means that trustees need to undertake a "bottom-up" approach to assessing this test, rather than a "top-down" approach – i.e. start by assessing the bottom entity in an investment chain and working up through the chain.

    c. The first exclusion outlined above is assets which are a means for investing in real property. There is no clear policy basis for this exclusion, but not an exclusion for (say) infrastructure.

76. To address these concerns with the <u>asset-based test</u>, we request that it be removed as it is unnecessary and the purpose-based test would still cover the field.

77. There are two concerns with the <u>purpose-based test</u>:

    (a) If an entity is not an interposed vehicle under the asset-based test, a purpose-based test must be applied. Different formulations of what is basically the same test are applied to listed and unlisted entities. The different formulations creates more complexity. The amendments continue to be extremely complex and need to be simplified further.

    (b) The purpose-based test relies on what is disclosed in a PDS. However, ASIC gives no guidance on how disclosure can impact the outcome. We have provided some possible examples in paragraph 72 above.

78. A possible change to the <u>purpose-based test</u> to go some way towards resolving the complexity of the Class Order is:

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(a) Amalgamate the listed and unlisted tests into one test – is it the end investment, and so is not an interposed vehicle, or is it the means of accessing the end investment, and so is an interposed vehicle.

Administration fee and Investment fee

[

79. These defined terms have been amended to clearly establish that "indirect costs" cannot be part of the administration fee or investment fee.

80. We request clarification on the following additional reference shown in bold "other than indirect costs **that are not paid out of the superannuation entity**". It is unclear what is meant by the phrase set out in bold.

81. These new defined terms will be inconsistent with the terms applied in the SIS Act in relation to the rules about how to establish a MySuper product (investment option). We question the need for these changes in view of the Indirect Cost provision and the resulting inconsistency with SIS terminology. The revised definitions of "administration fee" and "investment fee" will result in a divergence between the definition superannuation funds must apply under the law and the definition superannuation funds must disclose in a PDS.

82. 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 we consider many superannuation trustees would currently disclose as investment fees. Amounts can only be indirect costs to the extent that they are not charged to members as a fee. As such, it is circular to refer to "indirect costs" in the definition of investment fee. We anticipate that some superannuation funds would disclose the management fee in Example 14 (Superannuation Fund A) as an investment fee rather than as an indirect cost. It would be preferable to have an understanding of why ASIC considers it a better disclosure outcome to have this disclosed as an indirect cost. (See RG 000.124.)

Fee example

83. Changes have been made to the fee example without clear explanation of their impact. Presumably, they are made to make the example more flexible for those superannuation products which do not offer MySuper e.g. pensions. However, the draft Class Order does not contain any instructions on how the example should be completed. Ideally, a clause should be inserted confirming that the trustee is to insert either MySuper or another investment option, but is not required to do both.

84. References to "MySuper" have been replaced in the heading and preamble to the fee example, but they still remain in the table. All references should be amended.

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

86. The new "Note" below the fee example creates further differences between the superannuation and managed fund disclosure. Now only superannuation products need to disclose buy/sell spreads in the fee example but managed funds do not – what is the reason for this difference?

Consumer Advisory Warning (CAW)

87. 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 certainly not those that do not accept employer contributions, for example a superannuation pension offer. Therefore, a trustee should be able to omit the words "or your employer" if they are not applicable.

88. Alternatively, we suggest inserting 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. As another more preferable alternative, a trustee should simply be able to omit the words "or your employer" if they are not applicable – this then removes otiose words.

89. 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.*".

Periodic Statements – indirect costs and indirect fees

90. We believe these amendments have been included in view of the continuous problem that we have previously identified i.e. the periodic statement does not include a provision stating where indirect fees (i.e. administration fees and investment fees that are charged in a unit price) are to be positioned.

91. The amendments provided clearly anticipate two separate dollar amounts to be disclosed, one for indirect costs, the other for indirect fees. 'Indirect fees' is not terminology used in the Corporations Act or Regulations, and therefore we are not certain what is meant by this term (although we assume that the intent is to capture those fees that are struck via the unit price). The amendment also does not describe the amount that must be included for indirect fees (as it does for indirect costs).

92. 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

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in relation to the prescriptive disclosure. Accordingly, there is no guidance on how to calculate the dollar amount for indirect fees.

93. To ensure that all indirect fees and costs, which are not paid directly from a member's account, are disclosed in Periodic Statements in a clear and concise manner, they should be combined into one amount, as suggested in the following draft changes:

Suggested Drafting

Part 3—Fees and costs in periodic statements
Division 1—Other Management Costs and Indirect costs

301 Indirect costs related to investment and administration of accounts

- The following text and the appropriate amount, in dollars, must be inserted after the part of the periodic statement that itemises transactions during the period.

  Indirect costs of your investment

  This approximate amount has been deducted from your investment and includes amounts that have reduced the return on your investment but were not paid directly out of your account but are not charged directly to you as a fee .[[1]]

- The amount inserted must include:
  - for a MySuper product or an investment option offered by a superannuation entity—the indirect costs for the MySuper product or investment option and any other amounts not deducted directly from a member's account for the MySuper product or investment option[[2]] [[3]]; and
  - for an investment option offered by a managed investment scheme—all management costs not deducted directly from a product holder's account during the reporting period.

- The amount must be shown as a single total amount in dollars.

- The amount for a managed investment product must be calculated by multiplying the indirect cost ratio for the relevant investment option by the product holder's average account balance for the option over the reporting period.

[1] In drafting the changes, we have referred to the text of paragraph 301 prior the MySuper legislative changes.
[2] This drafting will capture those fees that are included in a unit price and not directly debited to a member's account (for example an investment fee, an administration fee and any buy-sell spread (the latter of which will include transactions costs as they have not been excluded for superannuation arrangements)).
[3] Again, in drafting this provision, we have referred to the text of paragraph 301 prior to the MySuper legislative changes.

General Comments: (1) period for fees – previous or future years (2) IBR; (3) Performance fees

94. The table below includes comments in relation to: (1) the period of fees/costs – previous or future; (2) incorporation by reference statements; and (3) performance fees – all as covered in the draft RG 97.

<table>
<tr><th>Fee or cost</th><th>Managed investment products</th><th>Superannuation products</th></tr>
<tr><td rowspan="2">General</td><td colspan="2">ASIC RG 000.24 and 000.29 state:

“All components of the ‘indirect costs’ must be based on the costs incurred during the previous financial year, except for new products…. If the trustee or RE becomes aware of information that renders an indirect cost amount that was disclosed in the PDS incorrect, the trustee or RE will be required to consider whether in light of this information the PDS is defective…” (RG 000.24)

“The indirect cost ratio that is disclosed for superannuation products or for managed investment products that is included in the management costs calculation is based on the previous financial year. It is not to be estimated based on possible future costs or performance except where the PDS is in respect of a MySuper product, investment option or registered managed investment scheme that has not completed a financial year.” (RG 000.29)

FSC Comment: If the trustee or RE prepares a PDS showing indirect costs based on those incurred during the previous financial year but knows at the time of issue that these amounts have since been rendered incorrect by subsequent events (e.g. an abnormal expense may have occurred in the previous financial year that is not representative of likely costs in future years or an existing fund may have changed its investment strategy which alters its cost base*), then the PDS could be defective immediately upon its issue.

* For example, different asset allocations or changes to the proportions of assets managed by various underlying specialist managers who charge differing fee types (e.g. a new interposed vehicle may have a performance fee) and/or percentages may alter a fund’s cost base.</td></tr>
<tr><td colspan="2">ASIC RG 000.28 states:

“For options other than the default or balanced option, information about indirect costs may be included in material that is incorporate (sic) by reference in a shorter PDS. As the law facilitates updating such incorporated disclosures while not updating the eight page PDS, doing so has lower cost and it is appropriate that the information should be updated if new information comes to light that means that a <u>previous estimate</u> [underling added for emphasis] is not known or is known to be inaccurate or if there are different updated amounts available from a new financial year.” (RG 000.28)

FSC Comments:

Firstly, part of this paragraph is likely to be read as contradictory to other requirements in the RG (i.e. that the indirect costs must be based on the actual indirect costs for the previous financial year, not a previous estimate – except for new products).

Secondly, in the (more likely than not) event that the change to indirect costs impacts the default or balanced option, the PDS would also need to be replaced. Once this occurs, all IBR documents (i.e. including any others that have nothing to do with fees and costs) would also need to be replaced since IBR documents have to clearly identify</td></tr>
</table>

<table>
<tr><th>Fee or cost</th><th>Managed investment products</th><th>Superannuation products</th></tr>
<tr><td></td><td colspan="2">the PDS they form part of (e.g. by reference to the replacement PDS issue date). Doing so actually results in higher, not lower, costs for the issuer which ironically could then further impact indirect costs (e.g. if this expense is subsequently charged to the fund).</td></tr>
<tr><td>Performance fees – general</td><td colspan="2">RG 000.82 - Minor Typographical Errors are underlined for ASIC consideration:

“Fees based on performance of an interposed entity (<u>sic – should be interposed vehicle?)</u> or for management of (<u>sic ‘a’ is missing)</u> subgroup of assets of an investment option should not be called a ‘performance fee’ in the PDS if that fee is referred to.” (RG 000.82)</td></tr>
<tr><td>Performance fees by product type</td><td>Draft ASIC RG states:

“In the case of managed investment products performance fees form part of management costs and if they are not payable to the responsible entity are indirect costs.” (RG 000.83)

FSC Comments:

This statement is potentially confusing since all performance fees, whether charged directly to the fund or incurred as an indirect cost, ultimately form part of the total management cost for the fund.

Therefore:
• if paid to the responsible entity, a performance fee is a direct management cost which must be a reasonable estimate of the performance fees that would be payable for the current period
• if not payable to the responsible entity, a performance fee is an indirect cost (which can’t be called a performance fee under RG 000.82) and must be based on the actual performance fees charged in the interposed vehicle during the last financial year.

Please refer to the following very common performance fee examples for an illustration of the anomalies the ASIC Guidance (RG 000.83 and surrounding paragraphs) creates and recommendation 2 covering how</td><td>Draft ASIC RG states:

“For superannuation products, amounts payable by the trustee out of the superannuation fund for investment and administration are treated as fees and not indirect costs. This includes payments to an investment managers (sic) acting for the trustee under a mandate including fees based on their performance or otherwise.” (RG 000.33)

“In the case of superannuation products, a performance fee must be included in the investment fee, although fees payable for performance of assets deducted in an interposed entity (<u>sic – should be interposed vehicle?)</u> should instead be considered indirect costs.” (RG 000.83)

“A performance fee or fees that form part of the investment fee for a superannuation fund, even if based on performance should be disclosed on a current basis i.e. what the investor is <u>going to be charged</u> [FSC underling added for emphasis] rather than being based on previous financial year’s results.” (RG 000.30)

Oddly RG 000.85 states (in contradiction to RG 000.33) that:

“Performance fees charged by any interposed vehicles or by investment managers under mandate form part of indirect cost…”

FSC Comments:

The trustee doesn’t know what performance fee an investor is going to be charged – can only estimate.

Therefore:

• if paid directly by the superannuation product, a</td></tr>
</table>

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Fee or cost	Managed investment products	Superannuation products
	these could be addressed by ASIC.	performance fee forms a component of the **investment fee** which must be a **reasonable estimate** of the performance fees that would be payable for the current period • if deducted in an interposed vehicle, a performance fee is an indirect cost and must be based on the **actual** performance fees charged in the interposed vehicle during the last financial year. ***Please refer to the following very common performance fee example for an illustration of the anomalies this creates and recommendation 2 covering how these could be addressed by ASIC.***

95. **<u>PERFORMANCE FEE EXAMPLE</u>: Refer to table above for background – anomalies and detriments** of **ASIC's approach:**

A superannuation fund investment option invests into a managed investment product that charges a performance fee payable to the responsible entity. The performance fees in that managed investment product over the past three financial fees have been 7% (2014/2015), 3% (2013/2014) and 2% (2012/2013).

In the current PDS for the managed investment product, the responsible entity has made a **reasonable estimate** of **4%** performance fee for the current (2015/2016) year, based on the average of the actual performance fees charged over the previous three financial years since the responsible entity is of the view that the stellar performance resulting in an abnormally high performance fee in the previous (2014/2015) year is not likely to be sustained (e.g. markets may have since eased) and that averaging the performance fees over a longer period is more likely to be representative of future performance fees. However, the PDS for the superannuation product would have to disclose a performance fee of **7%** instead for the same (2015/2016) year as it is an indirect cost for the investment option that **must** be based on the **actual** performance fees charged in the interposed vehicle for the last financial year.

This results in:

- the above obvious **differences** between the disclosed performance fees even though they ultimately both relate to the **same** investment performance.
- potentially **misleading disclosure**, particularly in the superannuation fund PDS, since a higher performance fee sets a higher investment return expectation (especially considering that the responsible entity of the interposed vehicle has determined that such a high expectation is unreasonable going forward).

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96. PERFORMANCE FEES - OBSERVATIONS/RECOMMENDATIONS FOR ASIC CONSIDERATION TO RECTIFY THE ANOMOLIES

Member comments – investment fee v administration fee

We refer to the background above including the performance fee example above and note the following observations and recommendations:

(a) Many fee definitions for superannuation products recognise that it could be difficult to allocate various fees into a single fee category and therefore include 'not otherwise charged as [other types of fees]' as part of the definition. For example, the most obvious potential for overlap occurs between **investment fees** and ad**ministration fees**. Therefore, it seems more important to ensure that total fees and costs are disclosed rather than obsessing over individual components and then also having differing rules applying to some fees and costs, both between and within product types, depending on whether they are charged directly or incurred indirectly.

(b) It is obviously impossible to know future performance fees that an investor is going to be charged and, since past performance is not necessarily indicative of future performance, **it should not be mandatory** to base any performance fees, whether charged directly or incurred indirectly in interposed vehicles, solely on past performance fees. A responsible entity or trustee should have the discretion to apply what it considers to be a (more) reasonable estimate. Having a uniform reasonable estimate approach would allow for consistency not only between products ultimately investing in the same underlying assets but also where a performance fee may comprise *both a direct (investment* fee/management cost) and indirect cost within the same product (e.g. where a managed investment scheme has both a performance fee payable to the responsible entity and also holds investments in an interposed vehicle where performance fees apply).

Other comments on Class Order

Derivatives

97. ***Paragraph 4(f) of Class Order Amendment***: For every derivative which a fund holds, the issuer will need to compare the "underlying return" of the "reference asset" to the actual return of the derivative. The test requires issuers to regularly ascertain the cost of the derivative on an ongoing basis which is necessarily based on the state of markets, liquidity, time to maturity, volatility etc. This creates uncertainty and difficulty in estimating costs of derivatives and could impact PDS disclosure especially in times of market volatility (for example, it may require updates to PDSs for hypothetical costs – being the issuer's estimate of acquisition cost and the price to trade the derivative immediately after acquisition). This gives rise to a number of issues, including the following:

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(a) It will not always be simple to identify the reference asset. A derivative may give exposure to a number of reference assets and they may change over time. Furthermore, there may not be a single reference asset or single pool of reference assets (e.g. a swap where the value depends on the interaction of the values of multiple pools of reference assets).

(b) Once the reference asset is identified, the fund will need to track changes in its value while the derivative is held. ***This is a significant additional 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 it expects to be exposed to for the period it expects to be exposed to it.

(c) The difference between actual return and 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. This will often not be the case. The derivative may include leverage, such that there is not a 1 to 1 correlation. There may be a negative correlation (e.g. the value of a put option will increase as the value of the reference asset decreases). In these instances, the reference between actual return and underlying return is not a measure of the costs of the derivative.

98. In addition, as a general comment, the 'costs' ASIC is looking for product issuers to disclose for OTC derivatives will in some cases be extremely difficult to determine, particularly where it is based on information that is proprietary to the counterparty (not the product issuer) to an OTC derivative and/or built into the structure and payment flows of the OTC and a such responsible entities (REs) will not have the reasonable ability to calculate or determine these amounts. In some instances, REs may be able to make a reasonable estimate of the difference between the underlying return and the actual return (less transaction costs) had the RE invested in the underlying directly, such as in the example given by ASIC where the payment flows are calculated by reference to a benchmark less 1%. However, where, for example, the payment flows are dependent on underlying fund performance, the RE will have to predict the fund performance for the year ahead. We query how a responsible entity could make even a reasonable estimate of that performance. The commentary given in RG 97 does not provide sufficient guidance to help responsible entities understand what needs to be disclosed and how; the example given in the RG 000.74 is just one simplistic version of an OTC derivative and does not aid in respect of OTC derivatives with other payment flow calculations.

99. In order to comply with the Class Order amendment each responsible entity will have to come up with their own methodologies to estimate the costs required by the Class Order and this will lead to varied disclosure amongst REs. As a result of the different methodologies adopted by responsible entities, comparability between products will be difficult.

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100. (**IOSCO**) We are aware that IOSCO recently issued a consultation report on fees and expenses of investment funds. The report addresses fee and costs disclosure. In the report, IOSCO recognises the difficulty in calculating transaction costs such as buy/sell spreads and that it may be difficult for managers to obtain specific information from counterparties about implicit costs. The report asks stakeholders critical questions about whether implicit transaction costs can be accurately quantified after the event or reliably estimated, and, importantly, asks how useful are such estimates to investors. If ASIC retains its position on the costs of derivatives, then given the extensive work IOSCO is undertaking to come up with a workable solution, we think it would beneficial to leverage off the research and findings of IOSCO regarding the disclosure of costs for OTC derivatives, once that is complete.

Other comments on ASIC's approach to derivatives

101. As we understand the Class Order, ASIC is still requiring disclosure of the buy/sell spread of an OTC derivative, where the relevant OTC derivative is an option to acquire or dispose of a financial product. Buy/sell spread is expressly excluded from the definition of management costs under the Corporations Act. It will be difficult for investment managers/responsible entities/RSE licensees (superannuation trustees) to calculate these amounts because: (a) the information will often be proprietary to the OTC counterparty; and (b) if this information is forward looking and not based on a simple formula, such as benchmark less 1%, REs will need to predict the future performance of funds and particular assets. Estimates made when the PDS is drafted may diverge substantially from the actual 'cost' actually incurred. In this instance, REs could risk having defective disclosure.

102. The Corporations Act clearly excludes brokerage from the definition of management costs, as it is a transaction cost. The Regulatory Guide should be amended so that it is clear that brokerage is a transaction cost that is excluded from the indirect cost calculation, not only excluded when the derivative is used for hedging. Paragraph 000.75 states:

> "*For managed investment products, as long as the relevant financial product is used for hedging purposes, the brokerage and any other costs associated with buying and selling the derivative are transaction costs and not management costs. Note: transaction costs are excluded under cl 102(2) from the calculation of management costs*."

This paragraph implies that brokerage costs are to be included in the management costs for OTC derivatives not used for hedging. ***ASIC's Class Order is directly inconsistent with the Corporations Regulations cl 103 of Schedule 10.***

103. The current definition of *relevant financial product* captures multiple types of OTC derivatives – convertibles, swaps, CFDs, CDSs, participatory notes and options. It will difficult to calculate the spread on many of these types of derivatives, particularly CFDs, participatory notes and some swaps where the spreads are built into the price of the product. The Class Order should exclude any derivatives/products for which an RE cannot reasonably obtain this cost.

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104. ***Paragraph 4(f) – definition of*** reference ***asset***: In notional 101A(3A) as inserted by clause 4(f) of the draft Class Order Amendment:

> ***reference asset*** means:
>
> > (i) in relation to a relevant financial product that is a derivative, means **the something else** that the amount of the consideration, or the value of the arrangement, is ultimate determined, derived from, or varies by reference to;
> >
> > (ii) in relation to a relevant financial product that is a security or managed investment product, has the meaning given by clause 101A(3A)(a)(ii)(D).

105. We understand the reference to "the something else" is derived from s 761D Corporations Act and we seek ASIC to confirm or clarify given enquiry from the FSC membership.

Technical comments on Interposed Vehicle definition

106. ***Paragraph 4(h) of Class Order Amendment***: In relation to paragraph 4(h):

(a) The subtle drafting differences between listed entities and unlisted is not conducive to simplicity.

(b) Notional clause 101B(4) would deem 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 clause 101B(1), (2) and (4). Property securities are carved out from the calculation in (1) by (2), however (4) makes no distinction between property and non-property investments. This appears to be unintended.

Other miscellaneous comments

107. ***Paragraph 4(n) of Class Order Amendment***: In relation to paragraph 4(n), this paragraph ***introduces*** the concept of **indirect fees** without ascribing a meaning to it. It is not clear which fees are intended to be captured.

108. ***Minor drafting comments – Paragraph 4(f)***: In relation to paragraph 4(f), in the definition of "reference ***asset***" in notional clause 101A(3A), the word "ultimate" should be "ultimately.

109. ***Minor drafting comments on draft Class Order– Paragraph 4(h)***: In relation to paragraph 4(h):

(a) Notional clause 101B(2) provides that certain assets are to be disregarded for the purposes of the 70% calculation. It should be clarified if such assets should simply not be treated as securities or financial products (i.e. excluded from the numerator only)

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or should be completed disregarded (i.e. excluded from both the numerator and denominator).

(b) The drafting of the opening words of notional clause 101B(4) should be clarified.

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

Comments on Regulatory Guide – General Comments

110. As a general comment, the updated draft RG97 lacks clarity, in certain parts, as to which parts of the guidance might ***only*** be applicable to a managed investment scheme, which areas are relevant only to MySuper products, or whether certain paragraphs are to be applied across the entire product band. We are hopeful that ASIC will address this in due course.

111. **We are still concerned that the guidance provided around indirect costs, is not qualified by any measure of materiality** – which in industry's view, can lead to a disproportionate amount of time and costs spent on identifying and calculating such costs. To reiterate our 2 March 2015 submission (in particular, see the example set out at paragraph 16 of that submission), in many cases, certain costs (e.g. as they relate to OTC derivatives) might simply be unobtainable, or the cost and work associated with identifying such costs can be so burdensome that the administration costs can in fact dwarf the indirect costs that are ultimately identified – to the detriment of investors.

112. Many industry participants already feel strongly that they are using their best efforts to account for indirect costs and would highlight that it is in fact against the interests of a trustee to not properly identify costs and expenses associated with a scheme. Any indirect costs that a trustee fails to account for will ultimately have a negative impact on performance and returns. Accordingly, imposing **prescriptive**, but unconstrained guidelines through RG97 – without any guidance as to the level of inquiry beyond which responsible entities are not expected to go) may have the effect of only marginally (if any at all) increasing transparency, at a cost to issuers/investors.

113. ***RG 000.24***: RG 000.24 refers to "indirect costs" must be based on the costs during the ***previous*** *financial year*. Does it need to be a *financial year*? FSC is informed that some funds have different year ends from a financial year – therefore we seek that for the logistical reason of PDS rolls, for the "year" to be flexible, i.e. either a *calendar year* or a *financial year*.

ASIC is suggesting "annual PDS" rolls – remove these statements from the RG

114. By RG 000.27 ASIC appears to be suggesting an annual PDS roll cycle from when the previous year's indirect costs have been confirmed (i.e. or else the PDS would not remain up to date). If this guidance proceeds it suggests that the industry may need to consider replacing most if not all PDSs early in each new financial year, which is simply unworkable. Our members have significant concerns with RG 000.27, which is not the law (or at best, is a serious over-simplification of the law to the extent it seeks to reflect the law of defective PDSs). RG 000.27 should be removed from ASIC's guidance.

115. (**RG 000.30**): This paragraph does not make sense (or we have struggled to make sense of it).

(a) **First Statement**: RG 000.30 states that:

> "in the case of a *fee* the trustee of a superannuation fund …pays on behalf of the fund to an operator of an interposed vehicle which forms part of the indirect cost calculation the *fee* should be included in calculating indirect costs in the previous financial year. This applies whether the fee is based on investment performance or not."

We understand from the most recent ASIC drafting that *fees* are not *indirect costs*.

(b) **Second Statement**: RG 000.30 then states that:

> "There is an exception for new products. A performance fee or fees that form part of the investment fee for a superannuation fund, even if based on performance should be disclosed on a current basis i.e. what the investor is going to be charged rather than being based on previous financial year's results."

The First Statement seems to relate to indirect costs and suggests that any performance fee of an interposed vehicle needs to be included in indirect costs. Please see our comments elsewhere that, for more effective disclosure, issuers should have the option to unbundle performance fees in interposed vehicles.

The Second Statement suggests that any performance fee which is part of the investment fee, should be disclosed on a current basis. How can a provider establish what is to be charged in respect of a fee that is based on future performance? If an *estimate* is to be provided, how is a provider to calculate that estimate if it cannot have regard to, where appropriate, the previous financial year's results? The Second Statement is confusing.

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Use of previous financial year for indirect costs – exception required where this would be misleading and deceptive

116. ASIC mandates the use of the previous financial year's indirect costs information for the PDS. However, there may be cases where a product issuer knows, at the time of issuing a PDS, that the previous year's information would no longer be a reliable indicator of present or future indirect costs – i.e. it might already be materially misleading. In such circumstances, it should be permissible for the product ***issuer*** to make a reasonable estimation. We suggest that the amending CO (in relation to Schedule 10 subclause 104(2) allow a reasonable estimate of future indirect costs to be used where to use the previous year's would, in the product issuer's reasonable opinion, make the PDS misleading and deceptive.

Indirect costs and buy-sell spread

117. ***RG 000.47*****:** See our comments above in relation to paragraph 4(h) of the Class Order (interposed vehicles).

118. ***RG 000.50*****:** This description of notional clause 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. However, this simply reflects the deeming under notional clause 101B(4). Even if an entity is not deemed to be an interposed vehicle under notional clause 101B(4) (i.e. because it is the end investment), the entity could still be an interposed vehicle under notional clause 101B(1).

119. ***RG 000.58*****:** If it is intended that responsible entities indefinitely look through multiple layers of interposed vehicles, this should be clearly specified in this paragraph. This paragraph only contemplated two layers. (See our comments elsewhere about the extent of drill-down through interposed vehicles to estimate costs.)

Using notes to disclose indirect costs

120. (**RG 000.68**): It is unclear whether this paragraph relates to the *fee example* or the *fee template* table. The Corporations Act provisions referred to in the note relate to "How to fill in the example of annual fees and costs".

Reducing management costs and indirect costs through income sharing arrangements

121. (**RG 000.70 and RG 000.71**): These paragraphs state that trading-off management costs and indirect costs should be a fee or indirect cost. Can ASIC please explain the distinction as to when such arrangements are a *fee* or an *indirect cost* as it is not currently clear which fee/cost position applies in respect of the fee template. For example, RG 000.70 suggests such arrangements should be quoted as an *indirect cost* whereas RG 000.71 contains an example (securities lending) which ASIC states should be considered an *investment fee*.

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Derivatives – other detailed comments

122. ***RG 000.78***: The scenario on which this example 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, it would need to estimate the fee for the year ahead. This would involve projecting the price of gold throughout the coming financial year (most likely bringing into consideration ASIC policy on forecasts), 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 these issues.

123. ***RG 000.79***: In ***relation*** to RG 000.79:

(c) This guidance appears to relate to notional 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 Amendment which introduces a new notional clause 101A(3).

(d) 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.

124. ***RG 000.79 and RG 000.80 – further comments:*** In relation to RG 000.79, the updated Class Order does remove the reference to indirect costs including the buy-sell spread on a financial product that is a derivative …, that is not able to be traded on a financial market at the time it is acquired. However, the updated draft RG 97 still makes reference to this point in RG 000.79 and RG 000.80 of the draft RG 97:

Difference between acquisition and disposal price

RG 000.79
We consider that generally, for both managed investment schemes and superannuation funds, the difference between the acquisition price and the disposal price at the time of making the transaction, is not a cost that needs to be included in the indirect cost of the fund. Therefore, a component for the spread does not need to be included in the costs calculation.

RG 000.80
However for relevant financial products the difference between the acquisition price and the price to close out the derivative immediately after its acquisition should be treated as an indirect cost for superannuation products and, for a registered scheme, if the relevant financial product was not acquired for hedging purposes this amount should be included in management cost. If the cost to close out the derivative immediately after

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> its acquisition is not known, it should be estimated. The object of including these costs is to better ensure that the costs involved in effecting the investment strategy are taken into account whether they are borne by the trustee or an interposed entity or are embedded in a relevant financial product.

125. The inclusion of the above appears to still require that management costs/indirect costs include both the "investment management cost" component of the OTC product (as set out under paragraphs RG 000.72 – RG 000.77), plus the buy-sell spread at acquisition of the OTC product (unless used for hedging purposes). ASIC note in RG 000.80 that "*The object of including these costs is to better ensure that the costs involved in effecting the investment strategy are taken into account whether they are borne by the trustee or an interposed entity or are embedded in a relevant financial product.*" However, as the buy-sell spread applicable to the OTC derivative may not always be incurred (i.e. if product is held to maturity) and may only be incurred where a manager is required to sell, terminate or close-out an OTC product to meet investor redemption needs, it is preferable to continue to reflect these costs in the transaction costs of a managed fund or superannuation product.

Consistency of terms throughout the RG

126. Through the RG the following references are used for the managed investment scheme which issues the PDS - "registered managed investment scheme', 'registered scheme', 'managed investment products', 'managed investment product option'. A consistent term should be used. Similarly, "interposed vehicle/entity" should be used consistently (although in the time available we have not checked every reference in the RG but presume ASIC will do so.).

127. Often the term "indirect cost ratio' is used when referring to 'indirect costs' for superannuation products ***and*** managed investment schemes. Given the 'indirect cost ratio' for MIS has a different meaning "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" it is not appropriate to use this generic term as it is misleading when applying it to MISs.

Minor drafting comments on RG

128. ***Draft RG 97 – Minor drafting comments***: Below are minor drafting comments on draft RG 97:

   (a) ***RG 000.1 – RG 000.3****: In respect of transition, the Regulatory Guide refers to Class Order 14/1252 both before and after modifications. This makes the guidance difficult to follow.*

   (b) ***RG 000.24****: The cross reference should be to paragraphs RG 000.36 and RG 000.37.*

   (c) ***RG 000.30****: This paragraph appears to be combining a number of distinct concepts. It combines discussion of indirect costs disclosure for new and existing funds and fee*

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disclosure. The references to "investment fee" should be removed from this paragraph, as this is dealt with in paragraphs RG 000.33 to RG 000.35.

(d) ***RG 000.36****: Indirect costs ratio should express indirect costs as a percentage of net assets, rather than as a percentage of total costs.*

(e) ***RG 000.42****: In the second sentence, the first occurrence of the word "these" should be removed.*

(f) ***RG 000.44****: Delete RG 000.44 as it has no text.*

(g) ***RG 000.43****: The reference to "a vehicle that is not an interposed vehicle or a business venture held by a non interposed vehicle" is unclear. The examples of a mine or airport should be expanded.*

(h) ***RG 000.129****: The words "When disclosing how and when in relation to switching fee" are unclear.*

Periodic statements

129. ASIC is proposing a new additional item for periodic statements, being for "**indirect fees**"; this will require system changes which can take substantial time. We are satisfied with the additional item for "indirect fees" however we note that system changes will be required. We suggest also providing *as an alternative* the option of retaining a single item but with wording describing that it is either the sum of indirect costs and fees, or indirect costs only and that indirect fees are not included but may be payable as disclosed in the PDS or other member information.

130. Further, we believe that most members' periodic statements would already include what ASIC now calls "indirect fees" in the existing indirect costs item – i.e. that current periodic statement disclosure would include a single amount representing the sum of both indirect costs and indirect fees. Accordingly we suggest retaining a single item but with wording describing that it is either the sum of indirect costs and fees, or indirect costs only and that indirect fees are not included but may be payable as disclosed in the PDS or other member information.

131. It is therefore particularly important that the transition period for periodic statements gives sufficient time to comply.

RG 97 - Sundry comments

132. (**Other fees and costs**): It would assist if ASIC gave guidance on how to complete the "Other fees and costs" row in the fee template.

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