DISCLOSURE OF FEES AND CHARGES IN MANAGED INVESTMENTS

Review of Current Australian Requirements and Options for Reform

Report to the Australian Securities and Investments Commission

Executive Summary

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Part 1

Executive Summary

Introduction

This report has been prepared at the request of ASIC as part of its ongoing commitment to ensure that the objectives of the Financial Services Reform Act 2001 ("**FSRA**") are achieved. The report focuses upon one aspect of disclosure – disclosure of fees and charges in Product Disclosure Statements ("**PDSs**") and member or investor periodic statements. As requested by ASIC, the report reviews current Australian disclosure requirements as well as international disclosure requirements, and proposes a number of options for improved disclosure.

As part of this project, 17 meetings were held with key stakeholders to discuss disclosure of fees and charges in PDSs and investor statements. The stakeholders included industry bodies, financial product issuers and consumer associations.

Disclosure Principles and Statistics on Managed Funds

Part 2 of the report provides an overview of the FSRA disclosure principles. These principles, as identified by ASIC in Policy Statement 168, are that disclosure should be timely, relevant and complete; promote product understanding; promote comparison of products; highlight important information; and have regard to consumers' needs. Part 2 also provides a description of typical fees and charges that relate to financial products. It also provides statistics on managed funds – both for Australia and internationally. As at 31 December 2001, total consolidated assets of managed funds institutions in Australia were $654.4 billion. Of this total amount, consolidated assets of superannuation funds stood at $303.4 billion; life insurance offices had consolidated assets of $176.6 billion; public unit trusts $130.9 billion and cash management trusts $30.1 billion. Growth of managed funds in Australia has been dramatic. Between June 1998 and December 2001, the consolidated assets of managed funds grew from $453.9 billion to $654.4 billion, an increase of 44 per cent.

Problems With Disclosure of Fees and Charges

Part 3 of the report identifies problems with disclosure of fees and charges. It is divided into two sections. The first section presents the results of surveys of the adequacy of disclosure of fees and charges in prospectuses. As part of this project, 30 prospectuses relating to various types of superannuation and managed funds were reviewed in order to obtain insight into the adequacy of disclosure of fees and charges. All prospectuses are recent and all have been issued by well-known product issuers. The following general comments can be made in relation to these prospectuses:

- There is significant variation with respect to the degree to which fees and charges are disclosed. This is evident not just in relation to a comparison of prospectuses for superannuation and prospectuses for managed funds, but also in relation to a comparison of prospectuses for the same products. For example, in some prospectuses, there is identification of fees and charges at a broad level. In other prospectuses, considerably more detail is provided concerning specific types of fees.
- There is significant variation with respect to how the same fee is described in different prospectuses. The use of different terminology to describe identical fees detracts from the ability to compare prospectuses.
- In some prospectuses, fees and charges are referred to but not defined.
- There is significant variation in relation to what the management expense ratio/ongoing management charge represents and how it is calculated.
- In some prospectuses, not all relevant fees are disclosed in the fees section of the prospectus which means that a potential investor must review all of the prospectus to see what fees apply.
- Many prospectuses do not disclose how much notice is required to investors in relation to an increase in fees and charges.
- There is significant variation in relation to whether prospectuses disclose the maximum fees or charges that can be levied under the trust deed.
- There is significant variation in relation to disclosure of the purpose for which fees are imposed.

The second section of Part 3 is a summary of the results of surveys which have been undertaken in the last few years with the objective of testing investors' understanding of fees and charges in prospectuses and other selling documents. These surveys have found that substantial numbers of investors fail to understand the fees that are disclosed in prospectuses. For many investors, the results show that it is difficult to understand the fee structure and it is not easy for them to work out exactly how much an investment will cost. For example, in one survey of 500 people who had invested in managed investments, 61 per cent agreed with the statement that "it is difficult to understand the fee structures". Another finding of this survey is that approximately one-third of those participating in the survey were unable to define the types of fees and charges they are paying in relation to their investment.

The review of prospectuses undertaken for this project and the results of the surveys of investors' understanding of fees and charges indicate considerable scope for improvement of the disclosure of fees and charges.

The Law Governing Disclosure of Fees and Charges in Australia

Part 4 of the report provides an analysis of the law governing disclosure of fees and charges in Australia. It highlights the important changes that have been made under the FSRA and focuses upon the enhanced disclosure requirements for superannuation.

International Review of Laws Governing Disclosure of Fees and Charges

Part 5 of the report provides a detailed review of the regulatory framework for disclosure of fees and charges in managed investments in the United Kingdom, New Zealand, Canada and the USA. This Part includes extracts from the fees sections of actual prospectuses in these countries in order to facilitate comparison with the Australian requirements. Part 5 also includes discussion of a recent development in a number of other countries – the implementation of fee calculators on the websites of regulators. This is an important initiative and in Part 6 of the report a recommendation is made for ASIC to consider the introduction of a fee calculator on its website.

Options For Improved Disclosure

Part 6 of the report identifies options for improved disclosure of fees and charges. It is divided into three sections:

- options for improved disclosure in PDSs;
- options for improved disclosure in periodic member statements; and
- options for implementation and the role of ASIC and industry.

Options for Improved Disclosure in PDSs

I make the following recommendations regarding improved disclosure of fees in PDSs.

Standardised descriptions and definitions of fees

- All relevant fees are to be referred to in the fees section of the PDS (this does not always occur currently).
- Even if a fee which is commonly imposed is not imposed in relation to a particular financial product, the fact that this fee is not imposed should be disclosed in the fees section of the PDS (this has the advantage of enhancing comparability of PDSs and eliminates the need on the part of a potential investor to search the entire PDS to identify whether a fee is imposed).
- The purpose of any fee which is imposed should be disclosed in the fees section of the PDS.
- To the maximum extent possible, there should be standardised descriptions and definitions of fees.
- A standardised fees table across all PDSs for financial products should be introduced which would identify significant fees (such as entry, exit, switching and investment management fees). Such a table could include the following (although the reference to establishment fee may need to be removed for non-superannuation products):

Type of Fee	**Amount (state Nil if not applicable)**
Establishment fee Contribution fee Administration fee Investment management fee Switching fee Withdrawal fee	

To what extent should fees be broken down?

I do not believe it is practical to disclose in a PDS a single global figure which contains all fees. As explained in more detail in Part 6, some fees are discretionary in the sense that some investors may pay them while others may not. In these circumstances, to include such discretionary fees in a single global figure can be misleading.

Neither do I believe it appropriate for every single fee which is paid to be disclosed in a PDS. A number of fees which are paid are very small and it would be unusual for these fees to impact upon the investment decision of a potential investor. However, I see merit in disclosing separately fees for administration and fees for investment management. This is for several reasons. First, they are different functions. Second, the separate disclosure of both administration and investment fees enables investors to compare how efficient each of these aspects is across a variety of financial products. Third, it is typically the case that investment management fees are the largest ongoing fees. It is important that the fee which is most directly related to the performance of the fund be separately disclosed. Finally, the distinction between administration and investment has become more important with the growth of master funds and IDPSs.

Entry/contribution fees and exit/withdrawal fees

Currently, there is a lack of consistent terminology for these fees across financial products. I therefore make the following recommendations:

- There is merit in having common terminology across both superannuation and managed funds products to enhance comparability.
- It may be, for the reasons outlined in Part 6, that the term contribution fee is more accurate than entry fee and that the term withdrawal fee is more accurate than exit fee. Consideration should be given to whether there can be uniform terminology across all products.
- If any of these fees are not applicable, this should be clearly stated as part of the fee disclosure table recommended above.
- The purpose of these fees should be disclosed in the fees section of the PDS.

Capacity to increase fees/maximum fees

I recommend that the capacity to increase fees and the maximum fees applicable be disclosed in the fees section of the PDS. Given that fees can typically be increased (and perhaps substantially) without the approval of investors it is important that investors be aware of this capacity to increase fees. It becomes even more important if a particular financial product has significant exit/withdrawal fees. If the capacity to increase fees and the maximum amount to which they can be increased is not disclosed, then an investor can be severely disadvantaged if fees are increased and an investor who wishes to withdraw is then subject to a high exit fee.

Ongoing management charge(OMC)/management expense ratio (MER)

These two ratios are designed as a measure of ongoing management expenses or charges in superannuation (OMC) and managed funds (MER). I make several recommendations for improved disclosure concerning the ratios:

- Comparability across superannuation and managed funds is reduced because different terminology for the two ratios is used and there is also a difference in the calculation of the two ratios (in particular, the MER excludes expenses that would have been incurred by a direct investor such as brokerage, stamp duty and costs in maintaining a property investment, while these expenses are included in the calculation of the OMC). I see merit in having the same terminology used across both superannuation and managed funds. Because both the ratios reflect ongoing management charges, the use of the term OMC would seem to be more accurate than MER. Consideration should be given to whether the terminology OMC can be used across all products.
- The fact that the two ratios are calculated differently but have as their objective measuring ongoing management charges detracts from the ability to compare products. I see merit in the Investment and Financial Services Association (which has published Standard No 4.00 for the calculation of the MER for its members) being invited to consider amending this Standard so that expenses which would be incurred by a direct investor are included in the MER. This

would align the MER with the OMC. It has the advantage of making the MER a more comprehensive ratio of ongoing charges. It also makes the MER a more straightforward and clearly explained ratio as it is not necessary to explain that it excludes expenses that would have been incurred by a direct investor.

- I see merit in having a standardised description of the OMC/MER for all financial products. My review of disclosure documents reveals a wide variation in the way these ratios are currently described. This is not helpful for investors. I suggest the following may be a useful starting point as a possible precedent which could be discussed with industry participants:

> The Management Expense Ratio/Ongoing Management Charge is a measure of the ongoing expenses associated with your investment. It is expressed as a percentage of the total assets of the fund (excluding liabilities). It includes:
>
> - **The ongoing investment management fee** – this is the annual fee the fund pays to [………] to manage your investment. In 2002 this fee was [……%] – see page [………]; and
> - **Other fees and expenses paid from the fund** – this includes certain administration costs associated with managing your investment such as the cost of maintaining the registry of members; printing costs of product disclosure statements, annual reports and member statements; the cost of producing cheques; postage expenses; fees charged by the fund's auditor and fees paid to custodians who hold the assets of the fund.
>
> The MER/OMC excludes entry/contribution fees, exit/withdrawal fees and switching fees.

- I also see merit in requiring a statement in all PDSs that past fees should not be taken as an indication of future fees. Currently, this statement is required only for superannuation products.
- The new requirements for superannuation require the OMC to be converted to a dollar amount for an account balance of $10,000. I see merit in having this type of disclosure for managed funds and note that a major product producer has recently done this in relation to one of the first PDSs for managed funds produced under the FSRA. This PDS shows the dollar effect of the MER by applying it to an account balance of $10,000 for each of the 15 investment options to which the PDS relates. I recommend that ASIC facilitate industry discussion with a view to determining whether industry is prepared to include this type of disclosure in PDSs for managed funds.

Showing the effect of fees on returns

An important issue is whether the effect of fees on returns should be disclosed in PDSs. Currently, this is not required for either superannuation or managed funds.

The key stakeholders consulted as part of this review expressed a broad range of views on this issue. On the one hand, the view was expressed that this is essential information for investors. The contrary view is that while it may be useful in theory, because of the assumptions required, which may prove to be inaccurate, the information cannot be rendered useful. The types of assumptions that need to be made are:

- the likely future returns;
- the likely future fees; and
- the likely future contributions by the investor.

Despite these difficulties, I note that some major countries require this type of disclosure. In particular, as noted in the international survey in Part 5 of the report, the United Kingdom, the United States and Canada require this type of disclosure for certain of their financial products. There are reasons why showing the effect of fees on returns can be useful. First, an increase in fees can reduce substantially future returns. For example, a 1 per cent increase in a fund's annual fees and charges can reduce an investor's final account balance in that fund by 18 per cent after 20 years.

A second reason why disclosure of the effect of fees on returns is important for investors is that some investment choices require this sort of information. For example, it is increasingly popular to offer investors different fee choices in relation to the same financial products. For example, a particular financial product may offer investors two choices concerning fees – (i) a nil entry fee with a higher OMC option or (ii) an entry fee with a lower OMC option. The investor cannot tell which is the preferred option without having some insight into the effect of the different fee options on returns.

I therefore see merit in ASIC facilitating industry discussion about disclosure of the effect of fees on returns subject to:

- a specified rate of return being set for industry participants; and
- appropriate disclosure about the assumptions which have been made.

I note that the Australian Consumers' Association has recently put forward for discussion a fee table relating to superannuation which discloses the effect of fees on returns. Ageing Agendas, in its report to the Australian Superannuation Funds of Australia ("**ASFA**"), has also recommended the use of a table showing the effect of fees on returns for superannuation products. In addition, Colin Grenfell, an actuary, has proposed a series of tables showing the effect of expenses on returns for superannuation products. I see merit in ASIC facilitating industry discussion about the merits of a table, which would show the effect of fees on returns, being included in PDSs relating to all superannuation products. This information could also be disclosed on a fee calculator on the ASIC website.

Disclosure in dollars versus disclosure in percentages

I recommend that ASIC facilitate industry discussion about achieving, to the maximum extent possible, disclosure of fees and charges expressed in dollars and not only in percentages. There is strong evidence that investors better understand and feel more comfortable with disclosure which is in dollars rather than percentages.

Disclosure of fees paid to advisers

I recommend that the fees section of PDSs contain disclosure of fees paid to advisers – both upon an initial investment and on an ongoing basis. I note that a number of PDSs already contain this type of disclosure. However, others do not and there is considerable variation in the quality of disclosure. I also recommend that the source for the payment of these fees to advisers be stated in PDSs. In the case of the ongoing trail, this will be the investment management fee. In the case of the initial investment, this will typically be the entry/contribution fee.

There is also the question about disclosure of "soft commissions" ie, other payments made to advisers which may include things such as bonuses for having clients invest specified amounts in certain financial products. Where these exist, I recommend that the PDS draws attention to the fact that arrangements may exist between the fund manager and financial advisers. Because of the variety of these arrangements and the fact that a fund manager may have different arrangements with financial advisers, it may be that only a general statement concerning the existence of such arrangements can be made in the PDS together with a statement that the investor should refer to the Financial Services Guide and Statement of Advice received from the adviser for specific details of these arrangements.

The buy/sell spread

A matter of confusion in disclosure documents is the so-called buy/sell spread. There is considerable variation in disclosure documents concerning this and, based upon consultations with key stakeholders conducted as part of this project, I am advised that it is a continuing source of concern for investors.

I see scope for improved disclosure in PDSs concerning the buy/sell spread and propose in Part 6 what I see as a useful precedent which could be discussed with industry so that there is a standardised description of the buy/sell spread.

Disclosure of ability to negotiate rebates with advisers

My review of current disclosure documents reveals a variety of practices concerning the extent to which they discuss the ability of investors to negotiate rebates with advisers. I see merit in having more standardised disclosure in this area. It is appropriate to have some statement to the effect that, where applicable, it is the adviser who determines the amount of the entry/contribution fee paid.

Options for improved disclosure in periodic member statements

Disclosure of fees and charges in periodic member statements varies to an extraordinary degree. Some periodic member statements make no disclosure to investors about fees and charges. This is unfortunate because it is this document which provides the opportunity for an investor to ascertain precisely what fees and charges have been paid in relation to their investment. This cannot be done in a PDS where there is a limit to the information that can be tailored to individual circumstances.

I view this situation with the utmost concern. I also note there is international interest in improving disclosure of fees and charges in periodic member statements.

I see considerable scope for improved disclosure of fees and charges in periodic member statements. I recommend that where actual fees relating to a member's investment can be calculated, then these fees should be disclosed in the statement. I was advised during the course of the consultations conducted as part of this project that for some funds the calculation of such fees might prove to be very costly in terms of the need to change computer systems. I recognise that these costs would be borne by investors. I therefore recommend that ASIC obtain information from industry about the costs of providing this disclosure. This would allow a cost/benefit analysis to be undertaken. I note in Part 6 of the report that the United States General Accounting Office has calculated that the cost of providing improved disclosure of fees and charges in investor annual statements would be less than $1 per investor per year. It would be important to ascertain what the costs of improved disclosure would be in the Australian context.

However, even if the costs of providing precise disclosure are significant, such is the importance of improving disclosure of fees in periodic member statements, that I make a further recommendation. I recommend that ASIC facilitate discussions with industry about recent proposals of the United States Securities and Exchange Commission and the United States General Accounting Office which are designed to deal with this situation. One proposal is to multiply the fund's per share (unit) asset value by the fund's expense ratio, multiply the result by the average number of shares (units) an investor owned during the period, and show the result in the investor's statement.

The second (and less costly) proposal to provide improved information about actual fees is to require member periodic statements to contain information about the dollar amount of fees that were paid during the relevant period for preset investment amounts. Periodic member statements would be required to include a table showing the cost in dollars incurred by an investor who invested a standardised amount (eg $10,000) in the fund, paid the fund's actual expenses, and earned the fund's actual return for the period. The Securities and Exchange Commission proposes there could be an additional table which would include the cost in dollars, based on the fund's actual expenses, of a standardised investment amount (eg $10,000) that earned a standardised return (eg 5%). Because the only variable for this calculation would be the level of expenses, investors could easily compare funds to one another.

Options for implementation and the role of ASIC and industry

I see an important role for ASIC and industry in ensuring there is improved disclosure of fees and charges in both PDSs and periodic member statements. Many of the recommendations made above to improve disclosure of fees and charges involve ASIC facilitating industry discussion.

I also make three further recommendations. These are:

- Consumer testing of the recommendations contained in this report.
- The possible introduction of a fee calculator on the ASIC website. I note that a number of regulators in other countries have made fee calculators available on their websites. I see significant merit in ASIC having a similar fee calculator and suggest this would contribute significantly to ASIC's educative mandate. Part 5 of the report provides detailed discussion of the fee calculators made available on the websites of the United States Securities and Exchange Commission and the Ontario Securities Commission and the Comparative Tables made available on the website of the United Kingdom Financial Services Authority. These provide useful precedents although I suggest in Part 6 that the fee calculator provided by the Ontario Securities Commission has a number of advantages.
- Facilitation of industry discussion concerning disclosure of information concerning fees and charges to trustees. I note the recent publication of the UK Pension Fund Disclosure Code. The objective of the Code is transparency in order to assist pension fund trustees' understanding of the fees and charges levied on pension fund assets for which they have responsibility. The background to the Code is a concern that a lack of comprehensive, clear and standardised disclosure has not allowed trustees and their advisers to monitor and compare all costs incurred during the management of fund assets. Because:

- a number of the key issues raised in the Code are similar to those which lie at the heart of this project; and
- improved disclosure of fees and charges to trustees has the potential to improve disclosure to retail investors;

I raise for the consideration of trustee and other industry bodies the desirability or otherwise of industry adopting a Code which would be similar to the UK Pension Fund Disclosure Code.