

**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**

**Section 6
Options for Improved Disclosure**

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Part 6

Options for Improved Disclosure

INTRODUCTION

In this section of the report options for improved disclosure of fees and charges in managed investments are proposed for the consideration of ASIC and industry.

It is worth recalling the Good Disclosure Principles from Policy Statement 168. These Principles were outlined in Part 2 of the report. According to the Principles, disclosure should:

- be timely;
- be relevant and complete;
- promote product understanding;
- promote comparison;
- highlight important information; and
- have regard to consumers' needs.

It has been said that the key purposes of disclosure standards in the area of fees and charges are to ensure that:²⁸²

- fees and commissions are transparent and readily understood by the average investor;
- investors have an understanding of the cost of entering into any contract;
- investors know the amount and timing of any remuneration to be received by the adviser from any investment decision;
- any investment decision is unbiased by the level of remuneration received by the adviser; and

²⁸² Phillips Fox, *Financial Services Reform Act: Product Disclosure of Fees, Charges and Commissions*, Report Prepared for ASIC, November 2000, p 5.

- investors can compare the cost of making an investment against alternate products in the marketplace.

As noted in Part 3 of this report, I believe there is a need for improved disclosure of fees and charges in relation to managed investments. This was a common theme running through many of the meetings with key stakeholders although not all stakeholders agreed in relation to the degree of improvement needed and what should be done to improve disclosure.

Part 3 of the report identifies a number of problems with existing disclosure of fees and charges. In that Part the results were presented of surveys of the adequacy of disclosure of fees and charges in prospectuses. These surveys showed there is considerable scope for the improvement of disclosure of fees and charges in prospectuses. This conclusion was reinforced by an examination of surveys, the results of which were summarised in Part 3, which have tested investors' understanding of fees and charges. The results of these surveys show that a significant number of investors fail to understand basic information about fees and charges.

Part 6 of the report contains the following sections:

- options for improved disclosure in Product Disclosure Statements (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

There are a number of issues that warrant consideration in relation to options for improved disclosure in PDSs. The issues discussed in this section are:

- standardised descriptions and definitions of fees;
- to what extent should fees be broken down?;
- entry/contribution fees;
- exit/withdrawal fees;
- capacity to increase fees/maximum fees;

- ongoing management charge/management expense ratio;
- showing the effect of fees on returns;
- disclosure in dollars versus disclosure in percentages;
- disclosure of fees paid to advisers;
- the buy/sell spread;
- disclosure of fees near returns; and
- disclosure of ability to negotiate rebates with advisers.

STANDARDISED DESCRIPTIONS AND DEFINITIONS OF FEES

In Policy Statement 168, ASIC states that an example of a disclosure issue that may benefit from clarification, particularly if greater comparability of products is to be achieved, is “standardised description of like fees and charges (such as commissions), including the basis for showing the future impact of fees and charges”.

It is clear from a perusal of existing prospectuses (see Part 3 of this report) that much more can be done to standardise descriptions and definitions of fees. The same fees are sometimes given different descriptions. Key stakeholders consulted as part of this project were generally supportive of more standardised descriptions of fees. In addition, relevant fees are not always disclosed in the section which deals with fees. For example, it is sometimes the case that switching fees are discussed not in the fees section of the prospectus but in another section. A potential investor therefore has to peruse all of the prospectus to identify whether fees may or may not apply.

Particular types of fees are discussed below. However, as a matter of principle, I see considerable merit in the following principles being adopted by those who prepare PDSs:

- All relevant fees are to be referred to in the fees section of the PDS (in some circumstances it might be appropriate for more detailed discussion of particular fees to be located elsewhere in the PDS provided there is an appropriate cross-reference from the fees section of the PDS where the fee is identified to the more detailed discussion elsewhere in the PDS).

- Even if a fee which is commonly imposed is not imposed in relation to a particular product, the fact that this fee is not imposed should be disclosed in the fees section of the PDS. For example, if a particular product does not have an entry fee, exit fee or switching fees applying to it, then this should be stated 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 (specific fees are discussed below).
- Consideration should be given to a standardised table across all PDSs for financial products which would identify significant fees (such as entry, exit, switching and investment management fees), state whether or not each fee applies to the particular product and, if so, state the amount of the fee.

There can be a higher degree of complexity of fees in relation to superannuation than some other financial products. However, it is still possible to have a table which identifies whether or not significant fees are applicable and, if so, the amount of the fees. Such a table in relation to a superannuation product could include the following:

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

The table can also be used for non-superannuation products (although the reference to establishment fee may need to be removed). This, or a similar type of table, would be located in the fees section of the PDS. In the same section of the PDS there would be a description of each of the relevant fees and also a statement about the purpose why each fee is imposed.

I now turn to discuss the extent to which fees should be broken down in a PDS and, following this, I discuss specific types of fees.

TO WHAT EXTENT SHOULD FEES BE BROKEN DOWN?

There is debate concerning the extent to which fees should be broken down and disclosed in PDSs. At one end of the spectrum, there is an argument that if it is possible to come up with a single global figure which captures all fees, then this has strong advantages for potential investors in terms of simplicity and enhancing comparability of PDSs. At the other end of the spectrum, there is the argument that separate disclosure of all applicable fees means that potential investors have all information in order to make an investment decision.

Both of these positions have difficulties and disadvantages associated with them. To come up with a single global figure which captures all fees may be impossible to do in any meaningful way. Some types of fees may be fixed dollar fees imposed each month or year. An administration fee in a superannuation fund is often this type of fixed dollar fee. Other types of fees are typically fixed percentage fees of certain amounts, such as the amount invested or the amount in the fund. To combine a fixed dollar fee and a percentage fee in a meaningful way is difficult and requires additional calculations.

A more significant difficulty with endeavouring to have a single global figure is that some fees are mandatory while others are discretionary. For example, a fund may impose switching fees. However, this fee will of course only apply to those investors who actually switch their investment. This means that a fee which is discretionary needs to be disclosed separately from those fees which are mandatory otherwise the single global figure has the potential to be very misleading. A similar point can be made in relation to exit fees. Entry fees may also be discretionary to the extent to which some investors may pay the full entry fee relevant to a financial product while others may have all or part of the entry fee rebated to them. In other words, disclosure of a single global figure which captures all fees may have initial attractions yet it can quickly be seen that a number of important fees would need to be disclosed separately.

I also note that of those countries whose disclosure requirements were reviewed for the purposes of this project, none had a single global figure which captures all fees (see Part 5 of this report).

In relation to whether or not all fees relating to a financial product should be disclosed separately in the PDS, the question is whether this can lead to an excess of information being disclosed to investors. For example, a manager of a fund may pay one or more custodian fees, typically of a small amount when compared to other fees. These fees are usually not disclosed and it is understandable why they are not as it would be unusual for these fees to impact upon the investment decision of a potential investor.

There is an important point in relation to the breakdown of fees between administration and investment management. I see considerable merit in requiring these fees to be disclosed separately. The reasons for this are as follows. First, they are different functions. Second, 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.

I now turn to discuss specific fees.

ENTRY/CONTRIBUTION FEES

As stated above, there is merit in moving to more standardised descriptions and definitions of fees. A fee which is paid to invest in a particular financial product may have different names. The review of prospectuses (summarised in Part 3 of this report) reveals that this fee can be called an entry fee, a contribution fee or a deposit fee. References to it being a deposit fee are rare. Usually, it is called a contribution fee in relation to superannuation products and an entry fee in relation to managed funds.

I see merit in seeing if it is possible to adopt common terminology for this fee across superannuation and managed funds. This would fit with the Financial Services Reform

Act objective of enhancing comparability of financial products. The challenge is that both of the terms are well entrenched in the marketplace. It might be possible to interpret the term entry fee as implying that it is a one-off payment (ie paid only when an investor first invests or “enters”). In fact, it is common for these fees to be paid on further investments in the same fund by the same investor although a reduced fee might be applicable. In these circumstances, the term contribution fee would seem to be more accurate. A contribution fee can be paid when one first invests and can also be paid in relation to subsequent investments or contributions. In summary, I see merit in determining whether the term contribution fee can be used across both superannuation and managed funds.

As noted above, even if a particular financial product does not have a contribution/entry fee, then this fact should be disclosed in the fees section of the PDS – as part of the fee disclosure table recommended above.

I recommend that the purpose of fees which are imposed be disclosed in the PDS. In relation contribution/entry fees, if this fee is to be used for adviser remuneration, then it is appropriate that this purpose be disclosed. After all, this fee can constitute a substantial percentage of an initial investment.

EXIT/WITHDRAWAL FEES

A similar issue in relation to terminology arises with this fee as with entry/contribution fees. An exit fee can also be called a withdrawal fee. I make recommendations in relation to this fee that are similar to my recommendations relating to entry/contribution fees. In particular:

- there is merit in having common terminology across both superannuation and managed funds to enhance comparability;
- it may be that the term withdrawal fee is more accurate than exit fee as a reference to exit fee may imply that one is entirely withdrawing an investment from a fund whereas a fee would still be payable for only a partial withdrawal;
- if no exit/withdrawal fee is applicable, this should be clearly stated as part of the fee disclosure table recommended above; and

- if an exit/withdrawal fee is payable, then the purpose of this fee should be disclosed.

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. Key stakeholders consulted as part of this project were generally supportive of this position. Given that fees can typically be increased (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.

In summary, where fees which are disclosed in the PDS can be increased this fact should be specifically stated in the fees section of the PDS and the maximum amount to which the fees can be increased should also be disclosed in this section.

ONGOING MANAGEMENT CHARGE/MANAGEMENT EXPENSE RATIO

This section discusses the ongoing management charge (“**OMC**”) and the management expense ratio (“**MER**”). It provides an overview of the OMC/MER and then makes several recommendations for improved disclosure.

Overview of OMC/MER

The OMC and MER are broadly similar, although they do have differences. In the case of the MER, the Investment and Financial Services Association (“**IFSA**”) has published IFSA Standard No 4.00 which specifies the principles to be adopted by its members when calculating MERs. IFSA Standard No 4.00 is an Appendix to this part of the report.

Paragraph 6.1 of Standard No 4.00 states that the purpose of the Standard is to:

- specify the principles to be adopted when calculating MERs;

- provide guidance in the interpretation and application of those principles; and
- specify the manner in which MERs are disclosed in offer documents and other reports to investors.

In relation to the purpose of MERs, paragraph 6.3 of Standard No 4.00 states:

The MER is to capture expenses, which are incurred by the operation of an unlisted Scheme. Expenses, which would be incurred by a direct investor in the same assets, should be excluded where these can be identified and isolated. The aim is to show investors what extra costs they are paying by using an unlisted managed vehicle.

Two important features of the MER are to be noted. First, it is intended to provide a measure of ongoing costs and expenses. Second, it is a measure of the *additional* ongoing costs arising from the use of a managed investment vehicle. Consequently, the MER excludes:

- entry and exit fees (as these are not ongoing costs);
- government taxes and charges unless a direct investor would not have paid these;
- transaction costs such as brokerage and stamp duty as these would be incurred by a direct investor; and
- operating costs and expenses that would be incurred by a direct investor such as, in the case of property investments, repair, maintenance and refurbishment costs (Standard No 4.00, paragraph 10.1).

The MER is to be presented in tabular form for the last three completed financial years (if the fund has existed for this period of time), made up as at the fund's balance date, together with a brief description of the method of calculating the MER (Standard No 4.00, paragraph 9.1).

For funds that offer more than one investment choice, a separate MER is required for each of those investment choices.

The MER is expressed as a percentage. There is no requirement to convert it to a dollar amount by applying the percentage to a specified sample dollar amount (for example, \$10,000 as occurs in the case of superannuation).

In the case of superannuation, calculation of the OMC is governed by Schedule 10 of the Corporations Regulations 2001. The formula was outlined in Part 4 of this report. There are specific disclosure obligations for the OMC which exceed those for the MER under the IFSA Standard. In particular, in the case of superannuation, the dollar amount of the OMC is to be shown by applying the OMC percentage to an account balance of \$10,000. Schedule 10B of the Corporations Regulations 2001 requires different disclosure of the OMC depending upon whether the PDS has a single investment strategy or multiple investment strategies. To make this clear, it is useful to repeat in this part of the report the table in Part 4 of the report summarising the disclosure of OMCs under the Corporations Regulations.

OMC Disclosure
Schedule 10B – Corporations Regulations

Single Strategy

- cl. 8.1
- Preamble statement
 - Overall OMC%, investment-mgmt OMC% and non-investment-mgmt OMC%
- cl. 8.4
- Explanation of effect of OMC
 - Example based on \$10,000 for overall fund/product
 - Statement of charges included in each of overall OMC, investment-management OMC and non-investment-management OMC
 - Prescribed statements
 - Warning to read charges section
 - Notice that past charges do not necessarily indicate future charges
 - Description of OMC and signpost

Multiple Strategy

- cl. 8.1
- Preamble statement
- cl. 8.2
- “For each identified investment strategy”: OMC% and converted amount, for each of overall OMC, investment-mgmt OMC and non-investment-mgmt OMC
- OR
- “In respect of all investment strategies”: a statement of the highest and lowest OMC% and converted amount, for each of overall OMC, investment-mgmt OMC and non-investment-mgmt OMC, and a notice that OMC calculations specific to particular strategies is available on request
- cl. 8.4
- Explanation of effect of OMC
 - Example based on \$10,000 for overall fund/product
 - Statement of charges included in each of overall OMC, investment-mgmt OMC and non-investment-mgmt OMC
 - Prescribed statements
 - Warning to read charges section
 - Notice that past charges do not necessarily indicate future charges
 - Description of OMC and signpost

The OMC and the MER are broadly similar. The key difference between the two measures is in relation to expenses that would have been incurred by a direct investor (such as brokerage, stamp duty and costs associated with the maintenance of a property investment). Under IFSA Standard No 4.00 these types of expenses are excluded from the calculation of the MER. However, under the definition of the OMC in Part 7.9 of the Corporations Regulations and the calculation of the OMC under Schedule 10 of the Regulations, these expenses are included in the calculation of the OMC.

The Value of OMC/MER

It has been argued that a shortcoming of the OMC/MER is that the measures exclude entry/contribution fees and exit/withdrawal fees. This is true but it needs to be remembered that the concept of the OMC/MER is *ongoing* management expenses or charges. Entry and exit fees are not automatic ongoing charges and therefore it is not appropriate to include them in the OMC/MER. In addition, the OMC/MER represents charges that have in fact been paid. Entry and exit fees can be discretionary fees. They may or may not be paid depending upon the circumstances of the investor. For example, an investor may have all or part of their entry fee rebated by an investment adviser.

A limit of the OMC/MER is that it is based on the cost to the average fund member or investor and not the actual cost to the member or investor. In summary, both the OMC/MER express all ongoing fees as a percentage of the average value of the fund during the relevant year. This will not necessarily be the actual fee paid by the investor. However, it is typically recognised that the OMC/MER provides useful information relating to relative costs across similar funds and can identify trends in relation to ongoing management charges and expenses over time. It is to be noted that similar operating expense ratios are used in other countries such as Canada, New Zealand and the United States (see the international review in Part 5 of this report). Later in this section I make recommendations concerning improved disclosure of fees and charges in periodic member statements. If adopted, the recommendations will improve disclosure to investors of fees and charges based on their individual circumstances.

However, I do have recommendations for improved disclosure concerning the OMC/MER and I now turn to these recommendations.

Standardised Terminology and Improved Descriptions

A key objective of the Financial Services Reform Act is to improve the ability of investors to compare financial products. The OMC/MER essentially reflect the same thing – a ratio of ongoing management charges. However, comparability across superannuation and managed funds is reduced when different terminology for the two ratios is used and there is 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 have two specific recommendations. First, I see merit in having the same terminology used across both superannuation and managed funds. To the extent to which the ratio reflects ongoing management charges, the use of the term OMC would seem to be more accurate than MER. I recognise that both terms are well entrenched in their respective parts of the financial sector. I see merit in IFSA being invited to consider changing from the use of the term MER in its Standard No 4.00 to the use of the term OMC.

The second recommendation concerns the difference in the way the two ratios are calculated. This detracts from the ability to compare products. I see merit in IFSA being invited to consider amending its Standard No 4.00 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.

In addition to the above two recommendations, I also see merit in having a standardised description of the OMC/MER for all financial products. My review of disclosure documents reveals wide variation in the way these ratios are 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 a statement which would be required 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.

In addition, should it turn out to be the case that the MER and the OMC continue to be calculated differently, then it would be important to have an additional statement in relation to the disclosure of the MER that costs such as brokerage and stamp duty are not included in the MER although they are paid from the fund.

Dollar Value of the MER

As noted above, Schedule 10B of the Corporations Regulations 2001 requires the OMC to be converted to a dollar amount for an account balance of \$10,000. There is a question whether this type of calculation should also be required for non-superannuation products.

I note this has been done in one of the first PDSs for managed funds produced under the new FSR regime. In Colonial First State’s FirstChoice Investments PDS dated 6 May 2002, the dollar value of the MER (which Colonial First State calls the “Ongoing Management Fee”) is shown for an account balance of \$10,000. Interestingly, this disclosure is made for each of the 15 investment options to which the PDS relates. The investment options range from cash through fixed interest and property securities to

geared global shares. The disclosure is made in a table which had three items – the investment option, the MER as a percentage and the MER converted to dollars based on a sample account balance of \$10,000.

I see merit in this type of disclosure given that surveys of investors show that where possible, investors can relate more easily to disclosure which is in dollars. Because improvement of the ability of investors to compare products is a feature of the new FSR regime, there is merit in endeavouring to have similar disclosure across both superannuation and managed funds. I see a role for ASIC in facilitating industry discussion with a view to determining whether industry is prepared to include this type of disclosure in PDSs for managed funds. As we have seen, one of the major fund managers has already voluntarily implemented such disclosure.

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.

Another limitation is that projected returns should vary across asset classes. Thus, over time, we would expect returns on shares to exceed returns on fixed interest investments. Consequently, there is an argument that specifying the one rate of return across all classes of asset or investment type is too limited. On the other hand, to have

different rates of returns specified for different asset classes or investments will complicate disclosure in PDSs which offer multiple investment options.

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 this report, the United Kingdom, the United States and Canada require this type of disclosure for certain of their financial products. Where this disclosure is required, the regulator needs to specify what the future rate of return is in order to avoid the understandable incentive on the part of product issuers to maximise the future rate of return.

In the United Kingdom, the Financial Services Authority (“FSA”) did, at one stage, consider withdrawing from prescribing projections on a standardised basis in product disclosure documents. However, the FSA concluded that it was undesirable to do so as the following extract from one of the FSA’s publications shows:²⁸³

We have considered whether the regulator should withdraw from prescribing the production of projections on a standardised basis. The arguments in favour of such a withdrawal are that consumers may place undue reliance on the figures precisely because they are standardised; that projections may give a misleading impression of what growth might be achieved; and that they imply a greater degree of certainty, and predictability than is warranted.

However, withdrawal would be difficult where products are targeted at achieving a particular outcome (eg mortgage or school fee repayment). For non-targeted products there is a different problem. The consumer appetite for an indication of “what will I get back” is so strong that in practice any void the regulator creates is likely to be filled by uncontrolled and unrecorded “back of the envelope” calculations, which give scope for unscrupulous advisers to use inappropriate rates or place an unwarranted emphasis on past performance. It could also be difficult to show the impact of charges on investment return without projections...

For these reasons, our current thinking is that on balance it will be necessary to continue using projections in the new product disclosure regime.

There are other 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% increase in a fund’s annual fees and charges can reduce an investor’s final account balance in that fund by 18% after 20 years.²⁸⁴

²⁸³ Financial Services Authority, *Informing Consumers: A Review of Product Information at the Point of Sale*, November 2000, paras 73-75.

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 product. 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. How is the investor to tell which is the preferred option without having some insight into the effect of the different fee options on returns? With the increase in choice being made available by product issuers there is also a greater obligation on them to disclose information concerning fees and charges.

The above considerations leads to the view that there is merit in disclosing 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.

The Australian Consumers' Association (“ACA”) in a recent submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into:

- ASIC Policy Statements made under the Financial Services Reform Act; and
- regulations made under that Act,

proposed a table for superannuation products which shows the effect of fees on returns.

²⁸⁴ United States Securities and Exchange Commission, *Report on Mutual Fund Fees and Expenses*, January 2001, p 4.

ACA FEE DISCLOSURE MODEL

Name: Date of birth: Commencing salary: Contributions: Account balance at inception: Fee structure for XXX Super fund					
Administration fees <ul style="list-style-type: none"> • \$x per week/month/year • -% of contributions Trustee fees <ul style="list-style-type: none"> • \$x per week/month/year • -% of account balance 		Fund manager fees <ul style="list-style-type: none"> • \$x per week/month/year • -% of account balance Other fees <ul style="list-style-type: none"> • \$x per week/month/year • -% contributions • -% of account balance 			
Sample Table for Disclosure Model					
Gross investment return					
Years	Salary \$	6% p.a		8% p.a	
		No Fees \$	XXX Fees \$	No Fees \$	XXX Fees \$
5	39,600	16,451	15,885	17,268	16,671
10	44,800	41,085	39,147	45,389	43,215
To age 55	56,000	116,940	108,629	142,694	132,188
To age 60	66,000	185,339	169,626	239,943	218,652
To age 65	71,400	281,466	253,670	387,656	347,209
Note: Fees expressed in \$'s, contributions and salaries increase by 3% p.a					

Ageing Agendas, in its report to ASFA, also recommended disclosure of the effect of fees on returns and proposed the following table (see Part 3 of this report).

AGEING AGENDAS (REPORT TO ASFA) FEE DISCLOSURE MODEL

Effect of fees on account balance – no entry fee option

Impact on account balance from	Compulsory employer contributions of 9% on annual pay of \$20,000 (\$1,800)	Compulsory employer contributions of 9% on annual pay of \$40,000 (\$3,600)
If withdrawn	Impact of Fees	Impact of Fees
after 2 years	\$ 250	\$ 410
after 5 years	\$ 490	\$ 730
after 10 years	\$1,440	\$2,260
after 20 years	\$5,720	\$9,630

Colin Grenfell, an actuary, has recommended a series of tables for superannuation PDSs designed to show the effect on returns of expenses (but not investment charges which would be disclosed separately) for periods up to 40 years. The tables he has proposed are included in Appendix Part 6-2 of this report. Mr Grenfell put forward these tables for consideration when consulted as part of this project and also in his submission to the current inquiry being conducted by the Senate Select Committee on Superannuation into superannuation and standards of living in retirement.

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. As stated above, I believe it important that investors have access to information which discloses the effect of fees upon returns. Later in this Part, I make recommendations concerning the possible introduction of a fee calculator on the ASIC website. It would seem appropriate that, if this recommendation is adopted, disclosure of the effect of fees on returns be made on the website.

DISCLOSURE IN DOLLARS VERSUS DISCLOSURE IN PERCENTAGES

There is strong evidence that investors better understand and feel more comfortable with disclosure which is in dollars rather than percentages. Some of this evidence was referred to in Part 3 of this report. Research in other countries has reached similar conclusions.²⁸⁵

²⁸⁵ Financial Services Authority, above n 283, para 92.

On the other hand, use of percentages can facilitate comparison across funds in relation to certain matters. For example, disclosure of the MER/OMC as a percentage can make it easy to compare these ratios across a number of different PDSs.

I therefore conclude that, where possible, disclosure should be made in both percentages and dollars. Sometimes, only dollar disclosure will be required. For example, a fund may impose a switching fee of \$50 per switch.

The MER has traditionally been described only as a percentage and this is what is required by IFSA Standard No 4.00. However, as noted above, a major fund manager has already in a recent PDS converted the MER for 15 investment options offered in that PDS to a dollar figure by applying the MER to a sample investment of \$10,000. This type of disclosure is desirable.

I therefore recommend that ASIC facilitate discussion among industry participants concerning the extent to which fees and charges can be expressed in both dollar terms and percentage terms.

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. Even for a PDS which offers multiple investment options, this disclosure can be done by way of a table which lists the investment options and then has two further columns – the fee paid to the adviser upon initial investment and also the ongoing trail paid per annum. 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 paid by the investor.

Sometimes disclosure documents contain a simple statement to the effect that fees paid to advisers are paid from the manager's own resources without any further disclosure.

This may create the impression that fees paid to advisers are not in effect borne by investors. Consequently, I believe it is appropriate for the source of fees paid to advisers to be disclosed in the PDS.

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. A useful precedent, drawn, with some changes, from a current PDS, is the following:

What is the difference between entry and exit unit prices?

There is a difference between the entry and exit unit price for the fund on any business day. The difference relates to transaction costs and is often called a “buy/sell spread”. When investors make new investments or withdrawals from the fund, the fund incurs some costs in buying new investments (when money is added to the fund) or selling investments (when withdrawals are made). So that existing investors do not continually bear the transaction costs resulting from new investments or withdrawals, all investors pay a set, average amount (a buy/sell spread) when they transact. This is calculated according to the particular types of investments the fund holds. Currently, the buy/sell spread is [...] %. Not all new investments or withdrawals cause transaction costs to be payable to the fund, for example, where an investment does not incur any significant costs, or when a new investment coincides with a withdrawal by someone else. However, to be consistent, we generally apply transaction costs to all investments and withdrawals from the fund.

Please note that transaction costs (buy/sell spread) are not fees paid to [the manager]. They are paid to the fund, to ensure equality between all investors. They may be altered at any time.

To give you an example, the transaction costs (buy/sell spread) on an investment of \$10,000 are \$50.

I see considerable merit in developing a standardised definition of the buy/sell spread. ASIC can play a role in facilitating industry discussion to achieve this.

DISCLOSURE OF FEES NEAR RETURNS

During the course of the consultations with key stakeholders conducted as part of this project, some stakeholders expressed the view that it is important to avoid having investors simply choose the option of investing in cash to avoid paying fees. To the extent to which this problem may exist for some uninformed investors, I suggest that it is appropriate for the fees section of PDSs to be adjacent to that section of the PDS which discloses returns. However, I do not suggest that this be mandatory. It is appropriate for those who design PDSs to have discretion regarding this matter. In addition, the recommended disclosure of the purpose of investment management fees should assist (see above discussion under the heading “Standardised Descriptions and Definitions of Fees”).

DISCLOSURE OF ABILITY TO NEGOTIATE REBATES WITH ADVISERS

A matter on which conflicting views were presented to me by key stakeholders during the consultation process was whether it is desirable to have in the fees section of a PDS a statement about the ability of an investor to have part or all of the entry fee rebated to the investor. My review of current disclosure documents reveals a variety of practices. In some documents, there is no disclosure. However, there is such disclosure in other documents. For example, to take disclosure documents by three prominent product issuers, ASGARD discloses that the initial fee is [%] “unless your financial adviser agrees to rebate part or all of their deposit fee remuneration”. Colonial First State has the following statement in its recent PDS: “Your adviser determines the entry fee you pay, up to the maximum shown. Where you do not use an adviser the maximum applies.” BT has the following statement: “Your adviser must specify any current and future rebates on the application form before we receive your investment.”

I see merit in having more standardised disclosure in this area. Investors can be disadvantaged by inadequate disclosure. 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

A theme running through the consultations with key stakeholders was the need to improve disclosure of fees and charges in periodic statements sent to members/investors. As noted earlier in this report, disclosure of fees and charges in these types of statements varies to an extraordinary degree. Some periodic statements make no disclosure 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 selling document (PDS) where there is a limit to the information that can be tailored to individual circumstances. In addition, as noted earlier in this report, it seems sensible to assume that member/investor statements may be more closely read than many PDSs. This is for several reasons. First, the typical member/investor statement is considerably shorter than the typical selling document. Second, it is the member/investor statement which gives details of the value of the existing investment and the investor therefore has a financial incentive to review the statement.

As noted in Part 3 of this report, there are member/investor statements which provide no details concerning fees and charges. The statement may provide only a dollar value for the opening balance at the beginning of the period and a dollar value for the closing balance at the end of the relevant period, with no indication of the amount of fees and charges which have been paid. Although member/investor statements may be given quarterly, six-monthly or yearly, once a year the investor will receive, along with the statement, an annual report. In this annual report, there can be expected to be reference to the MER. However, it is often the case that there is no reference on the member/investor statement to the fact that the MER is disclosed in the annual report and, in any event, the MER does not always give a precise measure of the actual fees and charges relevant to a particular investor.

I note that there is concern at an international level with the inadequacy of disclosure of fees and charges in periodic member statements. In the United States, the General Accounting Office published a report in June 2000 on mutual fund fees. It is stated in this report.²⁸⁶

Mutual fund investors generally receive quarterly statements detailing their mutual fund accounts. These statements usually indicate the beginning and ending number of shares and the total dollar value of shares in each mutual fund owned. They do not show the dollar amount of operating expense fees that were deducted from the value of these shares during the previous quarter. This contrasts with most other financial products or services, such as bank accounts or brokerage services, for which customer fees are generally disclosed in specific dollar amounts...

One suggestion for increasing investor awareness was that mutual funds should disclose to each investor the actual dollar amount of the portion of the funds' fees they paid...Fund adviser officials GAO interviewed indicated that calculating such amounts exactly would entail systems changes and additional costs, but they also acknowledged that less costly means of calculating such amounts may exist. For example, instead of calculating the exact amount of fees charged to each account daily, a fund adviser could provide an estimate of the fees an investor paid by multiplying the average number of shares the investor held during the quarter by the fund's expense ratio for the quarter. Another alternative would be to provide the dollar amount of fees paid for preset investment amounts, such as \$1,000, which investors could use to estimate the amount they paid on their own accounts.

More recently, the United States Securities and Exchange Commission has considered improved disclosure of fees and charges in periodic member statements.²⁸⁷ The SEC's Division of Investment Management has recommended that additional fee information, including the dollar amount of fees, should be provided in periodic member statements. According to the Commission, "one advantage of this approach is that it would enable investors to not only compare the fees of funds but also to evaluate the fee information that would be contained in the reports to investors alongside other key information about the fund's operating results, including management's discussion of the fund's performance".²⁸⁸

The Commission notes that this additional information about actual fees paid could be presented in a variety of ways. One way 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

²⁸⁶ United States General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, June 2000, pp 13-14.

²⁸⁷ United States Securities and Exchange Commission, *Report on Mutual Fund Fees and Expenses*, January 2001.

²⁸⁸ *Ibid*, p 5.

(units) an investor owned during the period, and show the result in the investor's account statement.

A second (and less costly) way to provide improved information about actual fees is to require reports 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 Commission states that it could require, in addition, that the table 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.

The reason the Commission has proposed the second alternative is that it is conscious of the costs that could be imposed in terms of changing computer systems for the calculation of actual fees paid by investors in mutual funds. These costs would ultimately be borne by investors.

My main conclusion is that there is 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 on the statement. In relation to those funds where the calculation of such fees might prove to be costly, I recommend that ASIC obtain information from industry about the costs of providing this disclosure. This would allow a cost/benefit analysis to be undertaken.

The United States General Accounting Office, in its report on mutual fund fees, calculated that the costs to provide annual statements with improved disclosure would be less than \$1 per investor per year.²⁸⁹ 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

²⁸⁹ United States General Accounting Office, above n 286, p 79.

a further recommendation. I recommend that ASIC facilitate discussions with industry about the recommendations proposed by the US Securities and Exchange Commission and the US General Accounting Office. The first alternative provides more detailed information. The second alternative involves providing information about the dollar amount of fees that were paid during the relevant period for preset investment amounts. This would require investors to then estimate the amount they paid on their own accounts. However, there can be no doubting that this would be a substantial improvement over the current situation where little, if any, meaningful disclosure is made in many periodic member statements.

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. I have already made a number of specific recommendations to improve disclosure of fees and charges where I believe ASIC can facilitate industry discussion.

There are, however, three further issues which warrant discussion. These are:

- consumer testing of the recommendations contained in this report;
- the possible introduction of a calculator for fees and charges on the ASIC website; and
- facilitation of industry discussion concerning disclosure of fees and charges to trustees.

CONSUMER TESTING OF RECOMMENDATIONS

A view expressed by a number of those consulted as part of this project was the need to undertake consumer testing of recommendations where appropriate. I believe this is desirable. It has the advantage of ensuring that suggestions for improved disclosure of fees and charges are subject to evaluation by those who use disclosure documents for financial products. I therefore recommend that industry and consumer groups be invited to undertake consumer testing of the recommendations contained in this report, preferably in consultation with ASIC.

FUND FEE CALCULATORS

The Rationale for Calculators

The advent of the internet has signalled the emergence of web-enabled business models and technologies which have been embraced by the investment industry. The web has extended the marketing reach of financial product issuers, thus affording prospective investors with more information delivered in different ways.

Some product issuers and regulators have made available fee calculators on their websites. Issuers might make available such calculators in order to obtain a competitive advantage: investors may regard the offering of a calculator as a sign of honesty, integrity and transparency which may increase the perception of the issuer relative to other issuers. Regulators might make available calculators as part of their regulatory and oversight mandate: the deployment of calculators by bodies having an authoritative role in the market may lead to an increase in investor confidence in the market, as well as improve investor knowledge and understanding more generally. The emergence of web-enabled calculation software seems to have coincided with an increase in the complexity and variety of financial products.

Overview of the Calculators

Part 5 of this report contains details of fee calculators made available by regulators in other countries. The United States Securities and Exchange Commission (“SEC”) hosted fee calculator is rich in information. The calculator proceeds on a screen-by-screen basis, requiring the user to input information gleaned from fund prospectuses before proceeding through the subsequent screens. At the end, the calculator provides a detailed report outlining the quantum of fees attaching to the product, as well as information in respect of earnings foregone as a result of fees having been paid over the duration of the investment. The calculator is therefore able to contextualise fees against investment returns, which can be varied.

The rationale behind the SEC’s introduction of the calculator may be gleaned from the Chairman’s remarks upon the launch of the facility:

For some time...I have been concerned that the financial literacy of Americans has not kept pace with the growth of fund investments. I especially worry that investors do not understand the costs they pay for their mutual funds – and how those costs affect the amounts they will have in retirement or for their children’s educations.

Our own research shows that less than half of mutual fund investors know that fund expenses are deducted on an ongoing basis. Only 8 percent say they completely understand the expenses that their funds charge. These figures and other findings demonstrate how much education still needs to be done and the Cost Calculator can help.

...[T]he Cost Calculator will allow investors to understand the true cost of owning a particular fund, without being confused by the fund’s packaging. It will help us close the gap between the knowledge fund investors have and the knowledge they need.²⁹⁰

The SEC envisaged the calculator as reinforcing the aims of the prospectus fee table:

We have found...that there is a gap between the widespread availability of mutual fund cost information in the fee table and investors’ ability to use that information effectively. ...

The Cost Calculator is designed to...close the gap between the fee table and investors’ ability to use the fee table information to make a real-world investment decision.²⁹¹

The Ontario Securities Commission (“OSC”) hosted calculator is almost identical to the SEC calculator in approach: it is information rich and contextualises fees against returns. However, that is the extent of the similarities, for the OSC calculator is a one-screen software item that is fully-functional and variable in realtime. Unlike the SEC calculator, the OSC calculator enables the user to input all variables without proceeding through a series of input screens, and immediately thereupon calculates the fee and return results. The OSC calculator also presents a detailed report but does so immediately and in graphical pie-chart form. Although the OSC and SEC calculators are essentially the same, the OSC calculator is faster, more flexible and arguably more meaningful.

The Association of Superannuation Funds of Australia Limited (“ASFA”), in an important initiative, recently launched a web-based fee calculator. Unlike the preceding calculators, the ASFA calculator is not made available by a securities regulator but rather by an industry body. In a sense, an industry calculator seems to straddle the roles played by regulator calculators on the one hand and issuer calculators

²⁹⁰ SEC, *Remarks of Chairman Levitt: Media Briefing on Mutual Fund Cost Calculator* (6 April 1999), <http://www.sec.gov/news/extra/mfcalc.txt>.

²⁹¹ SEC, *Remarks of Paul Roye: Media Briefing on Mutual Fund Cost Calculator* (6 April 1999), <http://www.sec.gov/news/extra/mfroye.txt>.

on the other. However, the ASFA calculator is, understandably, given the role of ASFA, limited to superannuation funds.

FSA Comparative Tables

The UK Financial Services Authority does not provide a calculator as such but a set of user-definable Comparative Tables which set out the charge and deduction information for a range of products falling within the user's selected category. Insofar as the Tables serve as a calculator, they simply aggregate the readily-available fee and charge information for the products. The Tables are quite comprehensive in respect of the number of products covered. Throughout the consultation process in advance of the launch of the Tables, the FSA was keen to ensure that the Tables were as comprehensive as possible, covering as many products and issuers as possible, on the most relevant and objectively-verifiable data that would be of use to investors for comparative purposes. What the Tables lack in customisability, they make up for in comparability and range. It remains to be seen whether comparability and range outweigh the need for personalisation, the hallmarks of fee calculators.

Policy Considerations Underlying the FSA Comparative Tables

The FSA's concern with comparability stems from its educative mandate:

The tables are a key element of the FSA's campaign to boost consumers' understanding of financial services by arming them with accurate and relevant information before shopping around for the best deal.²⁹²

In earlier consultations promoting the FSA's educative strategy,²⁹³ the FSA noted that "many consumers are 'put off by the unfamiliarity, complexity and lack of transparency of market offerings'". The FSA was also concerned with "consumers' overall low levels of financial literacy, awareness of financial needs, understanding of what is available, and their ignorance of where and how to find out what they need to know".²⁹⁴

²⁹² FSA, *New Comparative Tables Will Help Shift Power to the Consumer* (Press Release, 30 May 2001), <http://www.fsa.gov.uk/pubs/press/2001/062.html>.

²⁹³ FSA, *Consultation Paper 15: Promoting Public Understanding of Financial Services: A Strategy for Consumer Education* (November 1998).

²⁹⁴ FSA, *Consultation Paper 28: Comparative Information for Financial Services* (October 1999), ¶4.1.

The FSA took the preliminary view that comparative information would overcome the weaknesses in the levels of consumer information which it had observed. The underlying rationale was to:²⁹⁵

- increase consumer confidence;
- provide information and knowledge to consumers;
- increase competition within the market;
- provide understandable and meaningful information to consumers;
- encourage consumers to seek professional advice;
- optimise the purchase process by assisting consumers to shop around; and
- do so reliably and authoritatively.

In that regard, the FSA concluded that a comparative information scheme would achieve those stated aims by:²⁹⁶

- serving as a non-advisory sales route for either an efficient immediate outcome or inspiration to seek advice;
- presenting information clearly and comparably;
- improving consumers' informational position vis-à-vis advisers; and
- allowing consumers simply to compare and contrast the charges of products and improve consumers' general bargaining position.

The FSA consequently concluded that such an approach would provide issuers with a great incentive to compete on price and quality. Combining these incentives with an improvement in consumers' understanding and bargaining position, the desired regulatory outcome of an efficient and fair market would be much more readily achieved with less regulatory intervention than might otherwise be required.²⁹⁷

Evaluation and Options

The OSC calculator appears to provide the most meaningful and user-friendly solution to the problem of personalised fee and charge calculations. It is easy to use, operates

²⁹⁵ Ibid, ¶¶4.4-4.26.

²⁹⁶ Ibid, ¶¶4.27-4.30.

by way of a graphic interface and provides detailed and comprehensive results, with pictorial representations.

I recommend that ASIC deploy a calculator similar to the OSC calculator. The justification for such an approach is found in the increasing need by investors to obtain personalised investment information and to obtain such information accurately, authoritatively and meaningfully.

ASIC would play an important role by serving as the authoritative delivery mechanism for the calculator. The FSA, in the lead up to the launch of the Comparative Tables, stressed the need for such a tool to be provided by an authoritative source.²⁹⁸ The deployment of such a calculator by ASIC would preserve the authoritative integrity of the calculator and, moreover, would contribute significantly to ASIC's educative mandate.

TRUSTEES' UNDERSTANDING OF FEES AND CHARGES

This project is concerned with disclosure of fees and charges in PDSs and periodic member statements. As previously noted, I see an important role for ASIC in facilitating industry discussion of the key issues identified earlier in this Part.

However, during the course of research for this project, I was made aware of the recent publication of the UK Pension Fund Disclosure Code. This Code of practice was drawn up by a joint working party of members of the Investment Management Association and the National Association of Pension Funds. 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.

²⁹⁷ Ibid, ¶4.31.

²⁹⁸ FSA, *Response to Consultation Paper 28: Comparative Information for Financial Services* (June 2000), ¶¶4.4-4.7.

The details of the main features of the Code are specified below. 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.

UK INVESTMENT MANAGEMENT ASSOCIATION**PENSION FUND DISCLOSURE CODE****2002****1 Scope**

The Code is designed to:

- be adopted by the managers of UK pension fund mandates;
- be applied to portfolios, or portions of portfolios, consisting of listed securities (including suspended securities previously listed), derivatives (where the underlying instruments are securities, financial indices, interest rates, dividends or foreign exchange), cash and pooled funds/collective investment schemes that invest in any of the above assets.
- address all explicit costs incurred by client pension funds, including broker commissions (direct, soft and recaptured), fund management and custody fees, foreign exchange charges, bank charges, taxation (stamp duty, VAT, etc) and any other costs.
- consider also the impact of implicit execution costs, eg the bid/ask spread, market impact and also opportunity costs.

The Code is limited to those custody costs borne directly by the fund, where the manager undertakes custody or has appointed custodians on behalf of clients. Withholding taxation on income is outside the scope of this Code.

In respect of those pooled funds/collective investment schemes managed by the manager or an associate, the Code provides that managers should disclose the costs incurred by each pooled fund as a whole. Attempts to attribute portions of costs to individual pension funds would be onerous and the results would not be meaningful. Although this “global” information is not currently disclosed in collective investment scheme report and accounts, it should be readily obtainable for “in-house” managed funds. The Code recognises, however, that it may not be possible for managers to obtain this level of detail from third-party funds and from investment trusts which, although they may be managed “in-house”, are the responsibility not of the manager but of the relevant boards of directors. In such circumstances, the Code requires prominent disclosure of any proportion of the portfolio that is invested in assets that are not compliant with the Code.

2 Disclosure Requirements

The Code only requires quantitative disclosure of costs that can be measured with certainty. For the other costs listed in Appendix 2, a description of the manager’s approach to handling them is required. The Code seeks to encourage disclosure of such costs without advocating any particular methodology as to how this is achieved. However, there is a requirement to state key aspects of methodology, so that informed readers can draw their own conclusions as to the usefulness of the narrative information presented.

It is both permissible and desirable that different house fund management styles, products and specific client requirements result in varying types of reporting. If any particular costs addressed by the Code are on occasion not relevant, or are perhaps more clearly explained by narrative rather than quantitative reporting, this should be noted in the relevant reports.

There are two distinct types of disclosure covered by the Code:

- Level One: company-wide policies, processes and procedures in relation to the management of costs incurred on behalf of clients (see Appendix 1).
- Level Two: client-specific information (see Appendix 2). The most important requirement here is for disaggregation by counterparties to transactions, to the extent and level of detail that provide meaningful information for clients.

The Code envisages that the frequency of client reporting will vary according to the type of disclosure. Level One disclosure should be updated annually, while the quantitative client-specific Level Two disclosure should be made at least six-monthly. In the event of any material Level One changes, these should be reported promptly to clients, not left until the next annual reporting date. These frequencies mirror FSA rules that require certain transaction reports to be made at minimum six-monthly intervals and, in the case of soft commissions, at least annually. More generally, clear, consistent, consolidated reporting is regarded as critical: it will not be helpful to trustees if managers disclose the various costs listed in the Code, or comply with FSA requirements, in a number of different reports or with different reporting dates.

Managers responsible for mandates of a number of different portfolios or asset classes for one scheme, should carefully consider whether it would be more helpful to the trustees if reporting was not fully consolidated but reported at portfolio or asset class level.

APPENDIX 1

LEVEL ONE DISCLOSURE

MANAGER'S POLICIES, PROCEDURES AND CONTROL PROCESSES

Period to which disclosure relates:

Dealing venues and methods – description of the various dealing venues used, eg different types of brokers, dealing for commission and dealing net, internal crossing, crossing networks, etc. How the manager decides between these alternatives and the impact that these decisions have on client transaction costs.

Broker selection and transaction volume allocation process – manager's processes, how brokers' relative competence is established with regard to execution, research, etc. How this results in business level targets for each broker/dealing avenue, how this is split between commission bearing, soft commission and net dealing and how progress towards and variations from these targets are monitored on an ongoing basis. Cross-reference to Level Two Disclosure, based on Appendix 2.

Variations in rates of commission – manager's processes for negotiating commission rates and the impact on rates of investment in different markets, eg UK/overseas, bond/equity, liquid/illiquid.

Soft commissions – manager's internal policy, justification (ie against potential lower commissions) and control processes to ensure compliance with current FSA regulations. Any change in this policy since the last report.

Commission recapture – if applicable to the particular client, a description of the process.

Dealing efficiency monitoring – manager's policy and procedures designed to maximise the value of client portfolios and to control transaction costs while still trading effectively. This will include policy, procedures and assumptions for assessing execution costs, including bid/offer spreads, market impact and opportunity costs, whether the manager measures these and how the results are used.

Conflicts of interest – procedures for complying with FSA requirements for fair treatment of clients in the execution of orders and allocation of trades, and procedures to identify and manage actual and potential conflicts of interest (including dealing through associates). How the manager complies with current FSA regulations on inducements. An approximate number, type and overall value of inducements logged over the period.

External and internal research – differentiation, reasons for choice and evaluation of the benefit received by clients from internal research relative to the cost of external research.

Access to and allocation of Initial Public Offerings and sub-underwriting – manager's policy plus procedures for complying with relevant FSA regulations and evaluation of the benefit received by clients relative to the cost of the necessary commissions paid.

Custody services – where the manager appointed the custodian, an outline of the manager’s selection, monitoring and review processes. Costs include transaction and holding charges.

Placing of deposits – manager’s policy on spreading deposits, in particular as regards placing deposits with associates, policy on credit ratings, use of money-market funds.

Foreign exchange transactions – manager’s policy in spreading foreign exchange transactions, in particular as regards placing these through associates, and policy on credit ratings.

APPENDIX 2
LEVEL TWO DISCLOSURE

Period to which disclosure relates:

Percentage of portfolio at period end not covered by the Code

eg, in third-party collective investment schemes, investment trusts, direct property, private equity, or in commodities.

Fund management fees and any other income derived by the manager

Custody costs borne directly by the fund, and to whom paid

Transaction values/commissions paid

- Transactions traded without commission, as percentage of total transactions
- Transactions subject to broker commissions, as percentage of total transactions
- Transactions subject to soft commissions, as percentage of total transactions
- Total commissions incurred for the period

Taxation

- VAT on Fund Management fees
- VAT on Custody fees
- Stamp duty paid on purchases
- Any other transaction taxes or levies

Other de minimis costs, eg PTM levy on transaction contract notes, need not be disclosed.

Appendix: Part 6 - 1

IFSA Standard No 4.00

Management Expense Ratio

Main features of this Standard are:

- **to specify the principles to be adopted when calculating MER's; and**
- **to provide guidance on the application of those principles, with particular emphasis placed on inter fund and master fund arrangements.**

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IFSA STANDARD NO. 4.00**1 Title**

- 1.1 This Standard may be cited as IFSA Standard No. 4.00 “Management Expense Ratio”.

2 Standards and Commentary

- 2.1 The standards set out in this Standard are shown in bold print, commentary is shown in normal print, immediately after a standard, as an aid to the interpretation of those standards.

3 Date of Issue

- 3.1 Originally issued 19 July 1999; updated May 2000.

4 Effective Date

- 4.1 This Standard should be applied in the calculation and presentation of MER’s on or after 1 August 2000. Earlier application of this Standard is permitted and encouraged.

5 Application

- 5.1 This Standard shall be applied by Scheme Operators when calculating and presenting the Management Expense Ratio (“MER”) for an unlisted Scheme or wholesale offering as defined in the IFSA Guidance Note No. 5.00 “Industry Terms and Definitions” (“Scheme”).
- 5.2 Where there is a conflict between the requirements of this Standard, applicable legislation, and the constituent documents of a Scheme, the requirements of this Standard should, having regard to the purpose of the Standard, be modified appropriately so that, as far as is practicable, the Scheme Operator complies with the requirements of this Standard.
- 5.3 The application of this Standard is not required for superannuation and life insurance products where legislation requires an Ongoing Management Charge to be calculated and disclosed.
- 5.4 If a member is unsure of the application of this Standard it should consult the IFSA Secretariat. The Secretariat will maintain a precedents file, but when it is unable to decide, guidance can be given by a special subcommittee of the Standards & Community Relations Committee.
- 5.5 Unincorporated investment vehicles that are listed on the stock exchange have their prices adjusted by the market to take account of their costs and performance. Therefore the cost of running these vehicles should not be taken into account when determining the MER of a Scheme which invests in them (in

the same way that an equity trust does not include the costs of running the companies in whose shares it invests).

6 **Statement of Purpose**

6.1 The purpose of this Standard is to:

- specify the principles to be adopted when calculating MER's;
- provide guidance in the interpretation and application of those principles; and
- specify the manner in which MER's are disclosed in offer documents and other reports to investors.

6.2 The purpose of the MER is to provide useful information for a potential investor. Directors have a responsibility to ensure statements made in offer documents and other reports to investors are not misleading. If for any reason a Scheme Operator considers the MER as calculated may be misleading, the MER should still be quoted with further information provided to investors which clarifies matters. Circumstances where additional disclosures may be provided may include:

- MER's calculated for periods which are not indicative of the future; or
- periods in which fees were waived or expenses were borne directly by the Scheme Operator.

6.3 The MER is to capture expenses, which are incurred by the operation of an unlisted Scheme. Expenses, which would be incurred by a direct investor in the same assets, should be excluded where these can be identified and isolated. The aim is to show investors what extra cost they are paying by using an unlisted managed vehicle.

7 **Application of Materiality**

7.1 Failure by a Scheme Operator to adopt or implement this standard is material if such failure has the potential to adversely affect the confidence of investors, prospective investors, other scheme operators, and other interested parties involved in the Managed Investments and Life Insurance industries.

8 **Definitions**

8.1 Refer to IFSA Guidance Note No. 5.00 "Industry Terms and Definitions".

9 **Presentation**

9.1 The MER shall be presented in tabular form for the last three completed financial years where possible, made up as at the Scheme's balance date, together with a brief description of the method of calculating the MER.

9.2 Where the financial year for the Scheme differs from June 30 the financial year for the Scheme shall be used and appropriate mention made in the MER table.

This is particularly relevant for Master Funds where a range of MERs are called for (see 13.7 and 13.9 below), and where MERs for some of the corresponding periods are unavailable.

- 9.3 Where the basis of the calculation of fees or expenses is changed or proposed to be changed and where the change would have affected the MER for the last completed financial year if such a change had been in effect, disclosure of the effect of the change shall be made.
- 9.4 In the case of an initial offer document no MER is required. The document may indicate that a cap will be applied to expenses.
- 9.5 Where a Scheme has not been in existence for a complete financial year the MER shall be shown either on an annualised basis with reference to the period covered and to the fact that the MER has been annualised or on an ‘estimated’ basis. (Refer 10.2 below).

10 **Formula**

- 10.1 For Schemes established for more than one year, the MER shall be calculated in accordance with the following formula:

$$\text{MER} = \frac{(\text{Fees} + \text{Recovered Expenses} - \text{ITCs})}{(\text{Average Scheme Size})} \times 100$$

Where:

Fees = fees that have been or will be deducted from the Scheme in respect of the period covered by the MER, including all the ongoing fees received by the Scheme Operator, whether in the form of cash or other consideration, (up-front and exit fees should not be included); all the fees of a trustee; any other fees such as local and overseas manager and custodian fees or audit fees; and any trailing commissions paid from the Scheme, expressed as a fixed amount. “Fees” include any amounts paid by the trust to the Australian Taxation Office under the GST Reverse Charge provisions.

Recovered Expenses = all expenses recovered from or paid out of the Scheme, incurred by the operation of the Scheme adjusted for the items set out below.

Expenses that would also be incurred by a direct investor in the underlying assets should not be included, for example, transaction costs; brokerage; and repair, maintenance and refurbishment costs.

Government taxes and charges, such as FID or BAD, on purchases and sales of the securities forming the Scheme’s underlying assets should be excluded.

Government taxes and charges for transacting on the investors account should be included if they are paid out of the Scheme but may be excluded if they are charged directly to the investor and the offer document discloses this.

GST incurred by the Fund will usually form part of the expense to which it relates (ie, GST charged on management fees). If the expense forms part of the MER, so then will the GST paid in relation to this expense. Therefore, if the expense falls outside the MER calculation, so will the GST paid in relation to this expense.

Schemes, which pay income or other tax (including capital gains tax), should exclude these expenses from the calculation.

Schemes, which undertake specific borrowings for the purpose of investing, should exclude the interest expense on these borrowings from the calculation.

ITCs = Input Tax Credits received or receivable from the Australian Taxation Office on expenses paid or payable by the Scheme, under the GST legislation. The reference to Input Tax Credits includes "Reduced Input Tax Credits".

Average Scheme Size = the result of a calculation made on a daily, weekly or monthly basis, using the same timing as the calculation (accrual) of a Scheme Operator's fees, obtained by:

- (i) adding together the Net Asset Values of the Scheme, including net income less expenses on an accrued basis, used at each fee calculation point during the financial year; and
- (ii) dividing the amount in (i) above by the number of days, weeks or months in the financial year in question, as appropriate.

10.2 For Schemes which have not been in existence for a complete financial year, the MER shall be calculated either:

(i) **On an annualised basis**

The formula in 10.1 is to be used, but on an annualised basis, with reference to the period covered and to the fact that the MER has been annualised;

OR

(ii) **On an estimated basis**

For example, Estimated MER = A + B + C

Where:

A = all variable fees defined as a percentage of assets (ie. Scheme Operator's fees, Trustee fees, and capped recovered expenses less ITCs recovered) added together. For example 1.5% + 0.5% + 0.1% = 2.1% The reference to "fees" above includes any amount paid or payable by the trust to the Australian Taxation office under the GST Reverse Charge provisions.

B = all other estimated costs (ie. bank charges, audit fees, etc less ITCs expected to be recovered or recoverable) divided by the expected average Scheme size for the coming year expressed as a percentage. For example $\$20,000/\$15,000,000 = 0.1\%$.

C = a percentage to give an amount of conservatism to the estimated MER (this may be necessary given that MERs are higher when a Scheme is in a growth stage. For example 0.2%) The manager may elect that it be zero%.

The total estimated MER = 2.4%

10.3 Where fees and expenses covered by the definition in 10.1 above are met directly by the Scheme Operator out of its management fee, they would not be included in the calculation of the MER.

11 **Inter-fund investments**

11.1 Inter-Fund investments may occur between funds operated by one manager (internal interfund investments) or between funds operated by different managers (discretionary and non discretionary master funds).

11.2 The principles underlying the issue of disclosure by all types of inter-fund investments are:

- the MER shall disclose all fees and expenses involved in investing through an interfund structure;
- the definition of an MER for master funds shall be robust enough to capture all types of master fund, namely, those where the investment mix is at the manager's discretion; and those where the investment mix is at the investor's discretion; and
- there must be consistency between all types of inter-fund investments.

12 **Internal inter-fund investments**

12.1 If there are inter-fund investments between funds operated by the same Scheme Operator then fees and expenses may be rebated in one or more of the funds. Where this is the case, only the annual fees of the trustee and/or Scheme Operator actually charged, and expenses actually recovered, in all funds in the inter-fund chain to the underlying asset portfolio should be included in the MER calculation e.g. where fees and expenses of one fund are rebated in full, there will be no amount included for that fund.

12.2 Conversely there may be duplication of trustee fees, particularly where there is a different trustee in one or more of the funds. In this case, all trustee fees actually charged in each fund should be added together in order to determine the MER of the head Scheme.

13 Master Funds

13.1 Master Funds where Scheme Operator makes asset allocation decisions

13.2 The total MER shall include both:

- the MER of the master fund itself, as defined by the MER formula at 10.1 above; plus
- the weighted average of the MERs of the funds in which the master fund has invested. This should be derived by calculating the average asset allocation percentage for the year in the underlying funds, applying these percentages to the latest available MERs of the underlying funds, and then totalling these amounts.

Example (1):

Scheme A is a master fund that invests in underlying Schemes B, C and D.

Scheme A's own MER is 1.50%

For ease of illustration, it is assumed that Scheme A calculates Scheme Operator's fees every three months.

Scheme A's total MER is calculated as follows:

Scheme A's Asset Allocation (\$M):

	Scheme B	Scheme C	Scheme D	Total Scheme
June-0X	10	15	20	45
Sep-0X	10	25	15	50
Dec-0X	30	15	10	55
Mar-0Y	<u>35</u>	<u>20</u>	<u>5</u>	<u>60</u>
	<u>85</u>	<u>75</u>	<u>50</u>	<u>210</u>
	(40.5%)	(35.7%)	(23.8%)	(100%)

MER of Underlying Schemes (%):

	Scheme B	Scheme C	Scheme D
Mar-0Y	1.30	1.50	2.00

Scheme A's Weighted MER (%):

	Scheme B	Scheme C	Scheme D	Total
Mar-0Y	0.53	0.54	0.48	1.55
12 month weighted average (%):			1.55	

Scheme A should disclose an MER of 3.05% (ie. 1.55 + 1.50)

- 13.3 Where the master fund invests in products for which an MER is not published (eg. an insurance bond) the master fund promoter shall make reasonable enquiries to determine the costs of investing in that product. The information obtained should be used in the calculation of the MER of the Schemes.
- 13.4 The master fund MER should include all relevant information, which can be gained about the extra cost of investing (refer to 6.3 above) in that product. The master fund MER should also include a disclaimer to the effect that the MER is not complete, and note those products for which an MER is not known.
- 13.5 It is recognised that in some instances, perhaps master fund investing into several sub-funds, it may not be possible to calculate an MER strictly in accordance with the formula as all the necessary input information will not be available. In these instances a ‘partial’ MER should be calculated using as much information as is available, and this should be quoted with a note explaining where it differs from a ‘full’ MER. As an example, “The MER of X% has been calculated taking into consideration all the management expense of the A Master Fund, and the MERs of the underlying Schemes where obtainable. We have been unable to obtain MERs for L Scheme, M Scheme, N Scheme and O Scheme, so investors who incorporate these Schemes into their A Master Fund Portfolio should be aware that the effective MER of their investment could be higher than the X% quoted above”.
- 13.6 *Master Fund with sliding fee scale*
- 13.7 Some Schemes may offer different management fees depending on the amount invested. Where this is the case two MERs should be calculated, one using the lowest management fee charged (x) and one using the highest management fee charged (y). The disclosure made should indicate that the Scheme’s MER is in the range x to y . No average MER should be stated for the Scheme unless the corresponding average investment is also stated.

Example (2):

Assume Scheme A’s management fees are as follows:

Less than \$5,000 invested	1.00% pa.
\$5,000 - 10,000	0.75% pa.
More than \$10,000	0.50% pa.

Assume Scheme A's own MER without the management fee included is 0.5%. Add this to the weighted average MERs of Schemes B, C and D (using assumptions in previous example).

Scheme A's total MER is calculated as follows:

$$0.5\% + 1.55\% = 2.05\%$$

Add Scheme A's lowest and highest fees:

$$2.05\% + 0.50\% = 2.55\%$$

$$2.05\% + 1.00\% = 3.05\%$$

Scheme A should disclose an MER in the range 2.55% to 3.05%.

13.8 *Master Fund where investor chooses underlying investments*

- 13.9 Where a master fund offers investors a choice between Schemes, the master fund MER and the MER of each underlying investment should be calculated and the total MER shown as a range of the lowest to the highest of the available options. In addition the latest MERs of the underlying Schemes should be shown separately where known along with the total MER, as these may affect an investor's choice of Schemes.

Example (3):

Scheme A offers investors a choice between Schemes B, C and D. Using the assumptions in Example (1) (ie. Scheme A's own MER is 1.5%) the MER for Scheme A would now contain the following information:

Scheme A's MER is in the range 2.8% to 3.5% depending on the choice of investments. The MERs of the underlying Schemes are:

	Underlying Scheme	Total MER
B	1.3%	2.8%
C	1.5%	3.0%
D	2.0%	3.5%

- 13.10 Where a master fund has a sliding fee scale as well as offering investors a choice of investments, the methodologies used in Examples (2) and (3) shall be combined to produce the lowest and highest range.
- 13.11 Some master funds offer investors the choice of options, which are not listed in the offer document (but may be made available by other means). In such cases the master fund offer document shall disclose the range of possible MERs but need not list separately the MERs of the available underlying funds.

Appendix: Part 6 - 2

Colin Grenfell Example

Expense Deduction Tables

COLIN GRENFELL EXAMPLE EXPENSE DEDUCTION TABLES**Table 1 – Retail Plan****The early years**

Warning: If you cash in during the early years you could get less back than you have paid in. Annual contributions are assumed to increase by 4.5% each year. The last three columns assume that investments will grow at 7% a year.

At end of year	Total paid in to date	Your investment if no deductions (except contributions tax) plus 7% a year	Effect of deductions to date	Variance
<u>Initial annual contribution \$2,500 :-</u>				
1	\$2,500	\$2,200	\$220	
2	\$5,110	\$4,650	\$360	
3	\$7,840	\$7,370	\$520	
4	\$10,700	\$10,400	\$740	
5	\$13,700	\$13,700	\$900	\$
10	\$30,700	\$36,400	\$3,200	\$
15	\$52,000	\$72,400	\$7,900	\$
20	\$78,400	\$128,000	\$17,000	\$
30	\$153,000	\$340,000	\$60,000	\$
40	\$268,000	\$805,000	\$177,000	\$
<u>Initial annual contribution \$5,000 :-</u>				
1	\$5,000	\$4,400	\$350	
2	\$10,220	\$9,300	\$560	
3	\$15,680	\$14,740	\$840	\$
4	\$21,400	\$20,800	\$1,200	\$
5	\$27,400	\$27,400	\$1,600	\$
10	\$61,400	\$72,800	\$5,700	\$
15	\$104,000	\$144,800	\$14,800	\$
20	\$156,800	\$256,000	\$31,000	\$
30	\$306,000	\$680,000	\$114,000	\$
40	\$536,000	\$1,610,000	\$344,000	\$

What are the deductions for ?

The deductions include the cost of commissions, expenses and charges (except investment expenses) and any surrender penalties and other adjustments. The deductions exclude the cost of life cover and any disablement insurance.

The last line of the table (for an initial annual contribution of \$5,000) shows that over a 40 year period the effect of the total deductions could amount to \$344,000.

Putting it another way, this would have the same effect as bringing investment growth down from 7% a year to 5.87% a year

Table 2 – Industry Plan**The early years**

Warning: If you cash in during the early years you could get less back than you have paid in. Annual contributions are assumed to increase by 4.5% each year. The last three columns assume that investments will grow at 7% a year.

At end of year	Total paid in to date	Your investment if no deductions (except contributions tax) plus 7% a year	Effect of deductions to date	What you might get back
<u>Initial annual contribution \$2,500 :-</u>				
1	\$2,500	\$2,200	\$70	\$2,130
2	\$5,110	\$4,650	\$110	\$4,540
3	\$7,840	\$7,370	\$160	\$7,210
4	\$10,700	\$10,400	\$230	\$10,170
5	\$13,700	\$13,700	\$300	\$13,400
10	\$30,700	\$36,400	\$700	\$35,700
15	\$52,000	\$72,400	\$1,400	\$71,000
20	\$78,400	\$128,000	\$2,400	\$125,600
30	\$153,000	\$340,000	\$7,000	\$333,000
40	\$268,000	\$805,000	\$16,000	\$789,000
<u>Initial annual contribution \$5,000 :-</u>				
1	\$5,000	\$4,400	\$70	\$4,330
2	\$10,220	\$9,300	\$110	\$9,190
3	\$15,680	\$14,740	\$160	\$14,580
4	\$21,400	\$20,800	\$230	\$20,570
5	\$27,400	\$27,400	\$300	\$27,100
10	\$61,400	\$72,800	\$700	\$72,100
15	\$104,000	\$144,800	\$1,400	\$143,400
20	\$156,800	\$256,000	\$2,400	\$253,600
30	\$306,000	\$680,000	\$7,000	\$673,000
40	\$536,000	\$1,610,000	\$16,000	\$1,594,000

What are the deductions for ?

The deductions include the cost of commissions, expenses and charges (except investment expenses) and any surrender penalties and other adjustments. The deductions exclude the cost of life cover and any disablement insurance.

The last line of the table (for an initial annual contribution of \$5,000) shows that over a 40 year period the effect of the total deductions could amount to \$16,000.

Putting it another way, this would have the same effect as bringing investment growth down from 7% a year to 6.95% a year

Table 3 – Bases

<u>Plan Design</u>		Retail Plan	Industry Plan
Non-Investment Fees			
Contribution 1st Yr Fee	(Add'l)	3.00%	0.00%
Contribution Annual Fee		2.00%	0.00%
Annual Charge		\$48.00	\$49.40
Charges linked to		CPI	AWOTE
Annual Charge Inflation		3.00%	4.50%
Management Fee	(of Assets)	1.00%	0.00%
Benefit Charge		\$60.00	\$20.00
Benefit Charge Inflation		3.00%	4.50%
Investment Fee	(of Assets)	0.50%	0.50%
 <u>Assumptions</u>			
Earning Rate (net of tax)		7.50%	7.50%
Salary Increases		4.50%	4.50%
SG Rate		9.00%	9.00%
Earning Rate net of Investment Fee		7.00%	7.00%
Earning Rate net of Investment and asset based Management Fees		6.00%	7.00%