AIMA Australia

Alternative Investment Management Association (AIMA)

The Forum for Hedge Funds, Managed Futures and Managed Currencies

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

By email: feeandcostdisclosure@asic.gov.au

27 February 2014

CONFIDENTIAL

Dear Mr Beydoun,

AIMA submissions
ASIC Class Order [CO 14/1252] and consequential changes to ASIC Regulatory Guide 97: ***Disclosing fees and costs in PDSs and periodic statements***

1. Background

1.1 We refer to ASIC Class Order [CO 14/1252] (***CO 14/1252***) and ASIC's proposed consequential changes to ASIC Regulatory Guide 97: *Disclosing fees and costs in PDSs and periodic statements* (***Draft RG 97***), and your request for feedback on Draft RG 97 by 27 February 2015.

1.2 Thank you for the opportunity to participate in the industry roundtable discussion held on 11 February 2015. We appreciate the invitation to attend and ASIC's willingness to listen to the Alternative Investment Management Association's feedback.

1.3 The Alternative Investment Management Association (***AIMA***) was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. It is a "not for profit" educational and research body that specifically represents participants in funds offering exposure to alternative asset classes (including, without limitation, hedge funds, futures funds and currency funds). Participants include service providers such as responsible entities, trustees, prime brokers, administrators, lawyers and accountants. AIMA's global membership is in excess of 1,500 corporate members, comprising over 8,000 individuals, worldwide based in more than 50 countries.

1.4 The Australia network of AIMA (***AIMA Australia***) specifically represents participants in alternative investments in Australia. AIMA Australia has over 70 corporate members, including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms investors, fund administrators, independent fund directors and institutional investors.

1.5 AIMA Australia members who offer alternative managed funds products into the retail space will be impacted by CO 14/1252 and Draft RG 97.

1.6 We note ASIC has not issued specific questions for industry to provide feedback. Rather, you have requested general feedback. We therefore work though Draft RG 97 and provide feedback in a sequential way. Because AIMA Australia generally represents participants in the managed funds industry, and not the superannuation industry, our feedback in relation to Draft RG 97 is limited to areas that relate to managed funds only.

2. CO 14/1252

General comments

2.1 In our original submissions dated 22 October 2014, AIMA stated that any review of the technical deficiencies of Schedule 10 of the *Corporations Act 2001 (Cth)* (***Corporations Act***) ought to be conducted holistically. We considered this was a matter for Treasury to address by way of amendments to the law, rather than by ASIC through class order. While AIMA still holds this view, clearly ASIC disagreed and proceeded to issue CO 14/1252. Given that CO 14/1252 is now in force, and is unlikely to be amended by ASIC in any material way, we therefore focus our comments on Draft RG 97 and its interaction with CO 14/1252.

2.2 For completeness, we note that a number of (but not all of) our concerns set out in our original submissions have been addressed, or attempted to be addressed, by ASIC in the final version of CO 14/1252. We welcome the improvements made by ASIC in this regard.

3. Draft RG 97 and indirect costs

What is an interposed vehicle?

3.1 Item 101 of Schedule 10 of the *Corporations Regulations 2001 (Cth)* (***Corporations Regulations***) as modified by CO 14/1252 now defines "interposed vehicle". Paragraph (a)(1) of that definition uses the expression "does not predominantly carry on a business of investment in securities or other financial products". We note:

(a) paragraph 26 of Draft RG 97 uses the expression "does not predominantly invest in securities or financial products";

(b) paragraphs 28 and 30 of Draft RG 97 use the expression "predominantly in the business of investing in securities or financial products"; and

(c) examples 5 and 8 in paragraph 33 of Draft RG 97 use the expression "predominantly invests in securities or financial products".

3.2 We query what is meant by the term "predominantly". We presume you mean the "main" or "principal" business undertaking of the relevant body, trust or partnership must be an investment in securities or financial products. Perhaps some guidance from you as to what you mean by the term "predominantly" would be helpful.

3.3 Further, we encourage ASIC to use consistent terminology throughout Draft RG 97 so that the expression "does not predominantly carry on a business of investment in securities or other financial products" is used (rather than omit the words "carry on a business" in various places).

3.4 The different treatment for superannuation and managed investments is not ideal and will lead to inconsistent disclosure and also adds further complexity to an already complex regime.

Examples of interposed vehicles

3.5 Generally we find the examples helpful. However, we make the following comments:

(a) Example 2 – the reason for why the underlying hedge funds are considered interposed vehicles could be made clearer. Currently the stated reason is because the underlying hedge funds provide exposure to other assets (i.e. international shares). Perhaps it is more accurate to say the underlying hedge funds are interposed vehicles because they themselves predominantly carry on a business of investment in securities or other financial products (i.e. international shares);

(b) Example 3 – it would be helpful to include an explanation as to why the vehicles are considered to be interposed vehicles;

(c) Example 4 - it would be helpful to include an explanation as to why the life company is considered to be an interposed vehicle;

(d) Example 5 – we believe the last sentence should read "This company is not an interposed vehicle because it is listed and *does not* predominantly invest in securities or financial products.";

(e) Example 6 – we believe the explanation as to why the trust is not an interposed vehicle should be extended to include the fact that the infrastructure trust does not itself predominantly carry on a business of investment in securities or other financial products (rather, it invests in infrastructure assets which are not financial products); and

(f) Example 7 - it would be helpful to include an explanation as to why the financial products are not considered to be interposed vehicles.

3.6 Further, we encourage ASIC to include additional examples of interposed vehicles that cover:

(a) a chain of interposed vehicles, where there is more than one layer of investments (ie funds of funds of funds); and

(b) where a managed fund uses an OTC derivative or other synthetic instrument to obtain economic exposure to financial products.

3.7 Inclusion of the above examples is particularly relevant to AIMA members. We therefore welcome the opportunity to review the additional draft examples prior to ASIC finalising them.

Estimating indirect costs

3.8 As noted in AIMA's original submissions, we are concerned that the requirement to *estimate* indirect costs potentially cuts across two important carve outs from the current legislative framework in so far as fee disclosure is concerned, namely:

(a) section 1013C of the Corporations Act; and

(b) section 1013F of the Corporations Act.

3.9 Pursuant to section 1013C(2) of the Corporations Act, the information required by sections 1013D and 1013E (which in turn refer to the main PDS content requirements and the general obligation to include information that might influence a decision to acquire) need only be included in the PDS to the extent to which it is *actually* known to the issuer and any director (amongst others). It follows that where fees and costs (direct and indirect) are not available to the responsible entity in any meaningful form such that they do not *actually* know these fees then they are not required to include them as part of the "management costs" in the PDS.

3.10 For example, many fund of fund managers have great difficulty in accurately disclosing the indirect costs associated with the funds into which a master fund may invest. This is particularly the case when the underlying funds are (without limitation):

(a) unrelated to the responsible entity of the master fund;

(b) not themselves subject to the enhanced fee disclosure requirements of the Corporations Act (either because the funds are wholesale only or are foreign funds);

(c) constantly changing (e.g. the basket of underlying funds is part of an actively managed portfolio of funds and is regularly updated); or

(d) are themselves subject to deep layering of further investments.

3.11 In the above circumstances, fees and indirect costs are often not reported to the responsible entity of the master fund in any meaningful way. Nor are they reported in a way that makes it possible to accurately estimate what the indirect costs of these funds may be. Estimation is often guesswork and can be materially wrong.

3.12 Further, pursuant to section 1013F of the Corporations Act, it may not be reasonable for a person considering, as a retail client, whether to acquire interests in a master fund which offers deep layering of investments to expect to find an estimate of indirect costs when the actual quantum is not known to the responsible entity or is not likely to be material. In considering whether it would not be reasonable for a person to find the information in the PDS, matters that may be taken into account include the nature of the product and its risk profile. In the case of a master fund that provides access to deep layering of investments which the investor could not access themselves, together with the risk and return profile of the master fund in the context of the investor's portfolio, an estimate (based on information that is not actually known to the responsible entity) would not reasonably be expected to be included in a PDS.

3.13 CO 14/1252 and Draft RG 97 have moved away from the concepts of actual knowledge (as required under section 1013C(2) of the Corporation's Act) and what is reasonable for a retail client to expect to see in a PDS (as required under section 1013F of the Corporations Act) to the notion that a product issuer must now reasonably estimate any indirect costs that are unknown.

3.14 We do not consider it appropriate that the clear and intentional carve outs provided by the legislature are narrowed by CO 14/1252 and Draft RG 97. Such serious modifications to the law should be made by way of regulation and in consultation with Treasury.

3.15 Notwithstanding our above comments, if ASIC persists with the view that an issuer must reasonably estimate any indirect costs that are unknown, then perhaps ASIC could provide guidance on when it is *not* reasonable to estimate. This guidance is particularly relevant for funds of funds of funds (i.e. funds with deep layering of investments) and funds that invest into offshore vehicles that do not apply the same fee disclosure regime as Schedule 10 of the Corporations Act.

The ICR is historical

3.16 Paragraph 37 of Draft RG 97 states that product issuers should have regard to ASIC Regulatory Guide 170: *Prospective financial information* (***RG 170***) when making reasonable estimates of indirect costs that will be paid in the future. We do not believe that references to forward looking statements and RG 170 are correct in this context.

3.17 The "indirect cost ratio" (***ICR***) is defined in item 104 of Schedule 10 of the Corporations Act. Specifically, item 104(2) states that the ICR for a PDS is to be determined for the financial year *before* the PDS is issued. In other words, the ICR is a retrospective figure. Draft RG 97 (and in particular paragraph 37) is inconsistent with item 104(2) of Schedule 10.

3.18 It follows that any documented procedures for estimating indirect costs would reflect historical indirect costs and not prospective financial information. Given that the procedures would reflect historical indirect costs (and therefore the estimates are more certain and will involve less subjective judgement), we do not consider it particularly useful to require product issuers to make available to investors a copy of its documented procedures or to positively inform investors that such a document exists and discourage ASIC from amending Draft RG 97 to include such requirements.

3.19 Please also refer to our discussion in section 4 of these submissions concerning the treatment of performance fees and our recommendation that historical performance fees be used as the basis for disclosing management costs in a PDS.

Inclusion of derivatives costs in indirect costs

3.20 CO 14/1252 amends the law so that the buy/sell spreads of OTC derivatives are now included in the definition of "indirect costs".

3.21 We query why ASIC is seeking to treat the buy/sell spreads of OTC derivatives differently to the transactional and operational costs for any other financial product. Neither the explanatory statement to CO 14/1252 nor commentary in Draft RG 97 provides any insight into ASIC's rationale.

3.22 In any event, we do not consider it appropriate that OTC derivatives be treated differently to other financial products (including other synthetic instruments that are not strictly OTC derivatives from a technical legal characterisation of the product but which operate in a similar manner).

3.23 We anticipate that the costs of entering into and disposing OTC derivatives are built into the buy/sell spread applied to the price of units of a managed fund. That is, the unit price is adjusted up to cover all transactional and operational costs of acquiring the assets of the managed fund (including OTC derivatives and their spreads) and adjusted down to cover all transactional and operational costs of selling the assets of the managed fund (including OTC derivatives and their spreads). To now include the buy/sell spreads of OTC derivatives in management costs would effectively double count the costs as they are already built into the buy/sell spread applied to units in the managed fund.

3.24 We are not aware of any fund managers abusing buy/sell spreads for unit prices and deliberately excluding the transactional and operational costs from the buy/sell spread applied to units in a managed fund. Indeed, fund managers are generally incentivised to be very accurate with their buy/sell spread estimates applied to units in managed funds because if the actual costs exceed their estimates, there is a drag on investment performance.

3.25 As an alternative to adjusting the sell spread on units in managed funds, some responsible entities may charge withdrawal fees to cover the costs of unwinding an OTC derivative contract on the disposal of units. Withdrawal fees will often vary depending on the time at which redemption of units occurs and will ultimately depend on the economic value the responsible entity achieves on the unwinding of the OTC derivative. The responsible entity may offer to provide those investors seeking to redeem their units with estimates of applicable withdrawal fees on any given day, but the actual withdrawal fee payable is not determined until the underlying OTC derivative is unwound and the redemption of units is processed. Investors are advised that the actual fee payable may be more or less than the estimate provided.

3.26 Withdrawal fees are not treated as management costs. To now include the buy/sell spreads of OTC derivatives in management costs would effectively double count the costs as they may already be disclosed as part of withdrawal fees.

3.27 Further, the costs of entering into, maintaining and divesting OTC derivative contracts can be highly complicated in nature and commercially very sensitive. The costs of entering into, maintaining and divesting OTC derivative may be reliant on several factors including (but not limited to) market liquidity, volatility, interest rates, market prices, foreign exchange rates, and the time remaining to maturity of the relevant OTC derivative. The impact of these factors is largely unknown at the time a PDS is issued and are dependent on the movement of financial markets. To therefore require a responsible entity to include these costs as part of the fund's management costs is too uncertain. We refer to our discussion earlier in this section 3 concerning the difficulties of estimating indirect costs.

3.28 We consider the better approach is to disclose in a PDS (where applicable) that:

(a) there are costs associated with the use of OTC derivatives (and these are typically categorised as transactional and operational in nature);

(b) these costs are deducted before any returns are paid out under the OTC derivatives; and

(c) any costs deducted will have the effect of reducing the returns an investor ultimately receives.

3.29 If ASIC insists that the buy/sell spreads of OTC derivatives must be treated as indirect costs (rather than transactional and operational costs), then we welcome the carve out provided in Draft RG 97 for OTC derivatives that are used for hedging purposes. However, greater guidance on what is meant by the term "hedging" is required. For example, some OTC derivatives involve constant proportion portfolio insurance (***CPPI***) or dynamic allocation which allow the counterparty to maintain an exposure to the upside potential of a risker asset while providing capital protection against the downside risk by maintaining a position to say a bond. Arguably this type of OTC derivative is a hedge and therefore the buy/sell spread associated with the hedge would not be required to be included in the fund's management costs. Is this intended?

Examples of how costs for various OTC derivatives should be treated

3.30 Generally we welcome examples in ASIC regulatory guides. However, we make the following comments on the examples provided in Draft RG 97:

(a) Example 9 – it would be helpful if you provided a worked example. For example, how do you envisage the buy/sell spread of the OTC swap to be disclosed? How will this meet the dollar disclosure requirements?

On what basis do you consider it necessary to quantify transaction costs given that Schedule 10 of the Corporations Regulations does not currently require this? If required, given the complexities of describing OTC derivative costs (see the discussion earlier in this section 3), how do you envisage the transaction costs of the OTC swap (e.g. brokerage) will be disclosed as a transaction cost? How will this meet the dollar disclosure requirements?;

(b) Example 10 – as only OTC derivatives are caught, the example should more clearly refer to an OTC currency swap (as opposed to a "currency futures contract"). Further, the example would benefit from a positive statement that because the OTC derivatives contract is a hedge, the buy/sell spread associated with that contract need not be disclosed.

3.31 In our view, the examples demonstrate just how difficult it is to meaningfully disclose the costs associated with OTC derivatives. The additional level of complexity and cost involved in disclosing these discrete fees and costs outweigh, in our view, any benefit to the investor. Query whether the general principles of "clear, concise and effective" disclosure can be adhered to. We again submit that the better approach is to simply disclose in a PDS that:

(a) there are costs associated with the use of OTC derivatives (and these are typically categorised as transactional and operational in nature);

(b) these costs are deducted before any returns are paid out under the OTC derivatives; and

(c) any costs deducted will have the effect of reducing the returns an investor ultimately receives.

4. Draft RG 97 and the treatment of performance fees

4.1 At paragraph 55 of Draft RG 97, ASIC refers to the "incorrect practices of non-disclosure [of performance fees] and using the previous year's performance fees to indicate the expected fees for the current year with no consideration of whether the amount is a reasonable estimate of excepted [sic] performance fees."

4.2 We disagree with ASIC's view that it is "incorrect" to use the previous year's performance fees to indicate the expected fees for the current year. In fact, we think it is often better for a responsible entity to use the previous year's performance fees for the following reasons:

(a) where performance fees are an indirect cost, they will necessarily be calculated using the ICR which is, by definition, based on the fees and costs incurred during the financial year *before* the PDS is issued. To require indirect performance fees to be based on the historical fees, yet direct performance fees to be based on a forecast is arbitrary;

(b) forecasting what a performance fee might be in the future is a difficult thing to do (impossible even). A number of assumptions completely outside the responsible entity's control need to be made, including assumptions as to how well the fund might perform, how well a benchmark might perform, what inflows and outflows might be made to the fund that may impact any negative carry forward, how markets behave in general and whether certain hurdles or high water marks are achieved. All of these can influence a performance fee. And all of these would require reasonable grounds to justify the forecast (which can be very difficult to provide).

4.3 We respectfully submit that the more prudent approach would be for ASIC to accept the widespread practice of disclosing performance fees (both direct and indirect) using historical performance fees (that is, based on the fees charged during the financial year *before* the PDS is issued), but encourage responsible entities to clearly disclose that past performance is not a reliable guide to future performance and that performance fees will depend on a number of variables that may differ from historical fees. Further, if a fund manager is aware of any matter that might make the historical performance fee unlikely to apply in the future (for example, because previous significant underperformance has been, or is on the brink of being, made good and consequently future performance fees are likely to be higher than historical performance fees), then the responsible entity might disclose such information in the PDS.

5. Draft RG 97 and updating short PDSs

5.1 Paragraph 74 of Draft RG 97 correctly states that a shorter PDS cannot issue a supplementary PDS, but rather can provide the relevant information in an updated shorter PDS or as an update to material incorporated by reference.

5.2 As a technical matter, it is not clear whether ASIC Class Order 03/237: *Updated information in product disclosure statements* (***CO 03/237***) is intended to apply to short PDSs. As you know, CO 03/237 provides a prescribed method by which an issuer can make the updated information available without having to issue a replacement (or supplementary) PDS in circumstances where the updated information is not "materially adverse". We welcome clarification that CO 03/237 is intended to apply to short PDSs and suggest that a note in Draft RG 97 to this effect would be beneficial.

6. Other matters

6.1 We note responsible entities are required to comply with CO 14/1252 (and additional guidance in Draft RG 97) from 1 January 2016, regardless of when a PDS is first given. Essentially this means issuers must roll their PDSs and comply with the new requirements by 1 January 2016.

6.2 We consider a 12-month transition period (less in the case of Draft RG 97 as it is not yet finalised) to be ambitious and will result in significant costs for issuers.

6.3 We strongly request ASIC reconsider its position and instead require PDSs for managed investment products *first* issued on or after **1 January 2016** to be subject to the requirements of CO 14/1252. Of course, should a responsible entity opt to comply with CO 14/1252 before 1 January 2016 then they should be permitted to do so.

6.4 A large number of AIMA Australia members will be required to roll their managed funds PDSs which, being predominantly hedge funds, are longer form PDSs. Rolling longer form PDSs is a significant and costly exercise for members. Given that AIMA Australia members have only recently had to roll their PDSs to comply with ASIC Regulatory Guide 240: *Hedge funds: improving disclosure*, a further roll as a result of ASIC changes in such a short space of time is unduly burdensome on our members. Ultimately, it is investors in the funds that wear the costs for what seems to be limited upside.

* * * * *

We welcome the opportunity to discuss any further changes you make to Draft RG 97 and our submissions with you further.

Yours sincerely

Nikki Bentley
Hon Legal Counsel and Chair of
Regulatory Committee
AIMA Australia