Alternative Investment Management Association
Australia

AIMA Australia

Alternative Investment Management Association (AIMA)
The Forum for Hedge Funds, Managed Futures and Managed Currencies

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By email: Maan.Beydoun@asic.gov.au

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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 Thank you for the opportunity to provide feedback on the revised draft ASIC Regulatory Guide 97: *Disclosing fees and costs in PDSs and periodic statements* (***Draft RG 97***), proposed amendments to ASIC Class Order [CO 14/1252] (***Variation to CO 14/1252***) and to participate in the industry roundtable discussion to be held on 9 September 2015. We appreciate ASIC's willingness to listen to the Alternative Investment Management Association's feedback.

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

1.3 We note that we have provided previous submissions on 22 October 2014 and 27 February 2015 to ASIC on RG97. We note that some of our concerns set out in our submissions have been addressed. We have not sought to repeat comments that have not been taken up in Draft RG97 on the assumption that ASIC has considered our earlier submissions. For completeness however, we confirm that those concerns set out in our earlier submissions that have not been addressed in Draft RG 97 generally subsist.

1.4 We are aware that the Financial Services Council is making a comprehensive submission and, whilst we are in general agreement with the Financial Services Council submission, we have limited our comments to those that are particularly relevant to hedge funds.

2. Draft RG 97 and indirect costs

Complex definition of "interposed vehicle"

2.1 We have considered the flowcharts that you provided to us by email on 1 September 2015 in relation to when a entity is an "interposed vehicle" and think it would be helpful to include a flowchart along these lines in Draft RG97 to help issuers work through the very complex definition of "interposed vehicle".

Examples of interposed vehicles

2.2 We encourage ASIC to include additional examples of interposed vehicles that cover:

(a) funds of funds of funds (e.g. a chain of interposed vehicles, such as an Australian registered scheme investing into a Cayman Islands feeder fund that in turn invests into a Cayman Islands master fund that in turn invests into say a long short portfolio of global listed stocks); and

(b) where a managed fund uses an OTC derivative to obtain economic exposure to financial products (e.g. an Australian registered scheme uses an OTC derivative to obtain economic exposure to an offshore fund that in turn invests in a basket of funds). In particular, the example could show that the OTC derivative does (or does not) impact the characterisation of the offshore fund as an interposed vehicle.

2.3 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.

Inclusion of OTC derivatives costs in indirect costs

2.4 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 an 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, in our view, unreasonable particularly when the fund may only have a small exposure to OTC derivatives.

2.5 Accordingly, we request that ASIC clarify that the "reasonable estimate" test operates so that where it is very costly and difficult to determine the costs, or there is only a small exposure to OTC derivatives within a fund, ASIC does not expect the costs to be included as indirect costs.

2.6 Further, we request that ASIC clarify that some costs associated with an OTC derivative such as brokerage can still be regarded as transactional and operational in nature and so it may be appropriate in some cases to disclose some costs as management costs and some as transactional and operational. There is no need to double count.

2.7 For completeness, we consider the better approach to disclosure of fees and costs associated with OTC derivatives is to *prominently* 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) describe what the costs might entail (e.g. the costs relate to spreads charged by the swap counterparty, collateral costs, interest rates, assumed tax rates for dividend payments, etc), how the costs are generally calculated, and what variables might influence the costs (e.g. market liquidity, volatility, interest rates, market prices, foreign exchange rates, and the time remaining to maturity of the relevant OTC derivative). The descriptions will vary depending on the sort of swap it is (e.g. interest rate swap, total return swap, currency swap etc);

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

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

2.8 If the information is disclosed *prominently* in the fees and costs section of the PDS, then investors have all the information they need to assess whether investing in a fund that uses an OTC derivative is appropriate compared to a fund that invests directly in the relevant assets. These costs (which we generally regard as transactional and operational in nature) need not be disclosed in the management costs to achieve ASIC's objectives of better disclosure.

Carve out for OTC derivatives used for hedging

2.9 We generally support the carve out from the requirement to disclose costs associated with OTC derivatives as management costs where such OTC derivatives are used for hedging purposes. However, we note that the definition of "hedging" is sufficiently broad that it essentially allows OTC derivatives that adopt dynamic allocation or constant proportion portfolio insurance (***CPPI***) to qualify as a hedging instrument. This is particularly the case where capital protection is embedded in the OTC derivative. We are not sure if this is intended.

3. Draft RG 97 and the treatment of performance fees

3.1 At paragraphs 85 and 86 of Draft RG 97, ASIC requires performance fees deducted from an indirect vehicle to be calculation on the ICR basis (i.e. an historical figure based on the previous full financial year) and fees deducted directly from the registered scheme to be calculated on a *current* basis (i.e. not based on the previous financial year's actual results but based on the responsible entity's reasonable estimate of prospective performance). You are therefore requiring a mix of historical and current calculations to be included in the annual example of fee and costs. This is confusing and, in our view, arbitrary.

3.2 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).

3.3 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.

4. General comments

4.1 By way of general comment:

(a) we welcome the clarification that ASIC CO [03/237]: *Updated information in product disclosure statements* does not apply to a shorter form PDS (but does apply to a longer form PDS);

(b) as far as possible, we encourage you to treat superannuation and managed funds products the same (and if not the same, then fairly). As many super funds invest in managed funds, it would be convenient if the fee disclosure requirements were, as far as practicable, the same;

(c) at table 1 of RG 97, you state "*all* investment options must also comply with the enhanced fee disclosure regulations". Please clarify if your intention is to require a simple managed investment scheme that offers only one investment option to incorporate by reference the information required by the enhanced fee disclosure regulations, notwithstanding that the shorter PDS includes the abbreviated fees and costs information ?;

(d) at paragraph 151(d) of Draft RG 97, you indicate that if a managed fund does not charge a contribution fee, then an issuer can modify the annual worked fee example to omit reference to the contribution fee. We welcome this confirmation; and

(e) paragraph 154 of Draft RG 97 refers to superannuation products only. Query whether it should be deleted from Part D of RG 97 altogether (as Part D related to managed investment products only).

5. Transition matters

5.1 We consider the transition period to be ambitious and confusing and will result in significant costs for issuers. We **strongly** request ASIC reconsider its position and instead require PDSs for managed investment products *first* issued on or after **1 January 2017** to be subject to the requirements of Variation to CO 14/1252. Of course, should a responsible entity opt to comply with the current CO 14/1252 or the Variation to CO/14/1252 before 1 January 2017 then they should be permitted to do so. However, the PDS should not need to specify which class order the issuer is relying on as this is not relevant information for a prospective investor.

5.2 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 and rolling PDSs as a result of ASIC changes in such a short space of time is unduly burdensome on our members. It is ultimately investors in the funds who wear the costs for what seems to be limited upside.

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We welcome the opportunity to discuss any further changes you make to Draft RG 97, Variation to CO 14/1252 and our submissions with you further.

Yours sincerely

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