26 February 2015

VIC/National Office
L 28 Casselden Pl
2 Lonsdale St
Melbourne 3000
P (03) 9657 4200
F (03) 9657 4201
www.cbussuper.com.au

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

By email: maan.beydoun@asic.gov.au

Dear Mr Beydoun,

CONFIDENTIAL SUBMISSION:
Draft ASIC Regulatory Guide 97: Disclosing fees and costs in PDSs and periodic statements (*RG97*).

We refer to our previous submission dated 29 August 2014 in relation to the (then) daft ASIC Class Order: Disclosure of Fees for superannuation and managed investment scheme responsible entities (the ***Class Order***).

We are now pleased to have the opportunity to express our views on RG97, and in particular to support product fee and costs transparency and how this can be improved for the benefit of members and investors. Please note that our comments are limited to the superannuation aspects of RG97 only.

Our approach to reporting investment fees and costs

Cbus is a $28 billion, all profit to members, industry superannuation fund for those in the Australian construction, building and allied industries.

Cbus takes a full and transparent disclosure approach to reporting fees and costs. We believe that members have a right to know the full costs of their superannuation. As a consequence, we already include the costs and fees from not only the first level of management, but also costs associated with underlying managers.

Cbus is encouraged that ASIC has now released draft RG97 which seeks to clarify what indirect costs are and the Trustees' obligations for disclosure. Cbus strongly agrees with the principle of incorporating costs that go back to the asset itself, rather than to a particular level, or layer, of indirect costs.

RG97 should result in more consistency in disclosure on fees and costs and should improve the ability for members to compare fees and costs across funds. From Cbus' perspective, it should improve our ability to obtain information from investment managers (as our request is supported by law and clear regulatory guidance) and, once disclosed, ensure we are compared on a like for like basis.

Our response to the RG97 consultation

I have enclosed a detailed submission responding to certain of the questions raised in the draft RG97 consultation. Our comments are aimed at ensuring that ASIC's objectives of product fee and costs transparency can be properly implemented. I am happy to provide additional information should you need it.

Branch Offices:

ACT
PO Box 854
Dickson 2602
P (02) 6162 4946
F (02) 6162 4943

NSW
L 12, 44 Market St
Sydney 2000
P (02) 9262 3622
F (02) 9262 5388

QLD
L 2, 14 Campbell St
Bowen Hills 4006
P (07) 3257 0026
F (07) 3252 9004

SA/NT
L 3, 104 Frome St
Adelaide 5000
P (08) 8125 2515
F (08) 8125 2506

TAS
Ground Floor,
119 Macquarie St
Hobart 7000
P (03) 6220 8255
F (03) 6223 7003

WA
L 10, 233 Adelaide Terrace
Perth 6000
P (08) 9463 3944
F (08) 9463 3966

Cbus' Trustee: United Super Pty Ltd ABN 46 006 261 623 AFSL 233792 • Cbus ABN 75 493 363 262
General Advice Warning: This information is about Cbus. It doesn't take into account your specific needs, so you should look at your own financial position, objectives and requirements before making any financial decisions. Read the relevant Cbus Product Disclosure Statement to decide whether Cbus is right for you. Contact **1300 361 784** or visit **www.cbussuper.com.au** for a copy. Please refer to the Cbus Personal Information Collection Statement at **www.cbussuper.com.au/privacy** for details about how we collect and disclose personal information or contact us using the above number.
73 07/14

By way of summary, the key points we make in our submission are as follows:

- **Interposed Vehicle Definition**: The definition is very complex, meaning that very clear guidance is needed around the key concepts and calculation methodologies. Further examples should be given, and the use of diagrams may also assist;
- **Treatment of listed vs unlisted products**: These products appear to have been treated differently, which seems inconsistent with the objectives of promoting comparability and transparency.
- **Reasonably estimating costs which are not known**: Further guidance is needed, in particular around how far Trustees need to go in following the principles set out in RG 170;
- **Treatment of Superannuation and Managed Investment products**: Superannuation products are discriminated against in several respects, for example in relation to the treatment of fees and costs associated with investment in OTC derivatives;
- **Performance fees**: Due to their complexity, the inclusion of performance fees in the ICR should be based on actual fees charged, rather than a complicated prediction (which may end up being misleading); and
- **Insurance**: This should be dealt with in separate guidance.

We note that, to assist the aim of comparability and consistency in disclosure of indirect costs, it is also important that clarification of indirect costs is reflected in APRA's fee and cost reporting.

Review of RG97

Given the large number of complex technical issues presented by RG97 (and therefore the potential for divergence in interpretations and practices), we suggest that ASIC should consider whether it may be appropriate to flag that it may undertake a review of its guidance, say in one year's time following release of the final version of RG97.

***

Cbus looks forward to working with ASIC further on improving disclosure practices for superannuation fund members, with the overall aim of improving product consistency, transparency and comparability.

Yours sincerely,

Kerry Lindupp
Investment Communications Manager, Cbus.
Email: klindupp@cbusmail.com.au
Phone: (03) 9923 7140

<table>
<tr><th colspan="3">ASIC DRAFT RG 97: FEES AND COSTS DISCLOSURE</th></tr>
<tr><th>Topic</th><th>Feedback Question</th><th>Cbus comment</th></tr>
<tr><td>Interposed Vehicle</td><td>B1Q1 Do you consider the guidance provided on the interposed vehicles to be sufficient to properly explain when a body, trust, partnership or other structure would be an interposed vehicle?</td><td>Cbus strongly supports the guidance in RG 97 around the definition of Interposed Vehicle.
However, the definition of Interposed Vehicle is long and complex, and it needs to be explained in plain English.
Some of the key concepts require further and more detailed explanation. For example:
<u>Business of investment in securities</u>
The intended operation of the phrase "does not predominately carry on a business of investment in securities or other financial products" should be explained in more detail. In particular, the concept of "carrying on a business of investment in securities", is potentially confusing, and may be difficult to define precisely in certain circumstances[1].
Would it make sense to expand the guidance in relation to the phrase "business of investment in securities", for example by including further detail about what's actually intended. Otherwise, we feel there may be considerable scope for inconsistent application, and a lack of understanding amongst trustees around some of these key concepts.
ASIC may wish to consider making reference to comparative concepts (eg under the Investment Company Act 1940[2]), even if their sole purpose is to distinguish them from the concepts used in the Class Order?
Would it also make sense to expand the guidance to provide further information in relation to the term "predominately"? For example, what is the extent to which an entity can be carrying on a business other than an investment business before it ceases to be characterised as an Interposed Entity for the purpose of the Class Order? Is there a fixed percentage of activities which Trustees should focus on? We believe the absence of guidance on this concept could lead to inconsistent application of the Class Order among Trustees.
<u>Reasonableness test</u>
The reasonableness test is a key carve out to the Interposed Vehicle definition. In the absence of very clear guidance, we feel there may be scope for inconsistent application, and potential avoidance.
In particular, the circumstances in which a body, trust</td></tr>
</table>

[1] For example, under tax legislation, there is a substantial body of law in relation to the circumstances in which an entity can be considered to be carrying on an "*eligible investment business"* under Division 6C. Stapled security structures (both listed and unlisted) create particular difficulties, especially in relation to real estate and infrastructure vehicles.

[2] In the United States, we understand there can be considerable difficulty in accurately defining the circumstances in which an entity can be considered as being "*engaged primarily … in the business of investment in securities*" for the purposes of the Investment Company Act 1940 (United States).

		or other vehicle (whether listed or unlisted) *can reasonably be considered to be the ultimate assets that the product issuer is investing in* (and is therefore not an interposed vehicle under the Class Order) should be expanded on in the guidance. o For example, RG 97.27 suggests that if a PDS simply describes an investment option as offering exposure to a named listed property trust, rather than the investment in property through a trust structure, then the listed property trust should not be treated as an Interposed Vehicle for the purposes of the Class Order. This needs further clarification. In particular, RG 97 should make it clear whether naming the underlying vehicle in the PDS is sufficient to avoid the operation of the Class Order, or whether something more is required[3]. o We also believe that RG 97 needs to make it clear whether this carve out is limited to a <u>single</u> named fund/trust, and whether <u>multiple</u> funds can be listed/named in a PDS as a means for avoiding the application of the Interposed Vehicle definition[4]. • <u>Listed vs Unlisted products</u> o ASIC needs to be very clear about the differences in treatment of listed vs unlisted products as Interposed Vehicles. o Cbus does not believe there should be any fundamental differences in the treatment, although this is not clear in the guidance (see, example 8 in the guidance). Cbus is concerned about there being any difference for comparative purposes. o For example, ASIC needs to clarify the treatment of internally managed vehicles, as there appears to be scope for confusion in relation to the treatment of trustee operating costs vs investment management operating costs. • <u>Clarify the nature of the interest in Interposed Vehicles</u> o Presumably the size of the interest in the Interposed Vehicle is not relevant, however this should be clarified in the guidance. • <u>Consider the use of Diagrams</u> o Has ASIC considered whether illustrating the operation of the Class Order through the use of diagrams would be helpful?
	• **B1Q2** Are there additional examples that you consider should be included in RG 97 which would assist in clarifying or explaining the interposed vehicle	The examples provided in RG 97 are helpful. We also make the following suggestions: • We assume Example 5 is intended to provide that: o *This company is not an interposed vehicle because it does <u>not</u> predominately invest in securities or financial products* • Example 6 should provide further information around the exact nature of the disclosure in the PDS. • Further, as noted above, we suggest that RG97 should make it clear whether the carve-out referred to in RG97.27

[3] At first sight, this carve out from the Interposed Vehicle definition appears to be quite broad, and is potentially open to the possibility of abuse if the scope is not clarified.
[4] This is currently not clear in RG 97.28, which refers to naming investment in a trust, body or partnership <u>of a particular type</u>.

	definition and its application?	is limited to a single named fund (as opposed to multiple funds). • Example 8 needs clarification. In particular, the phrase "*AREITs are not interposed vehicles because they do not invest predominately in securities or financial products*", may not be correct in all cases. We understand that AREITs often invest in underlying real estate through a complex series of trusts, companies and other financial products. In addition, the treatment of AREITs which are stapled structures should be clarified. • A further issue is the question of why AREITs have been singled out as being exempt from the Interposed Vehicle definition, and in particular, why they should be treated any differently from unlisted property trusts? *Particularly where these holdings are held to gain exposure to the Property asset class.* • Examples in relation to use of fund of fund structures and holding investments through life insurance policies may be helpful. • An example of where a synthetic investment is used as a swap would be useful – guidance if this acts as a 'circuit breaker' for cost capture, that is, are the costs of the underlying fund included?
	• **B1Q3** The application of interposed vehicles and indirect cost varies between superannuation and managed investment products. Do you consider the proposed RG sufficiently explains these differences?	• Yes, the draft guidance is helpful in this regard. • However it is not clear why superannuation and managed investment vehicles are being treated differently from a policy standpoint (eg in relation to the disclosure of fees and costs for derivatives contracts).
Requirement to reasonably estimate costs that are known	• **B1Q4** Do you consider the guidance provided on the requirement to reasonably estimate indirect costs would assist you in complying with this requirement?	Cbus considers that further explanation is required in relation to requirement to *reasonably estimate* indirect costs. In particular: • Further detail is required around the extent to which Trustees need to have regard to RG 170 Prospective Financial Information. • RG 170 proscribes very detailed requirements in relation to the presentation of prospective financial information, including in relation to financial modelling and the verification of underlying assumptions. • Trustees need guidance on the extent to which financial modelling and analysis needs to be undertaken in order to comply with the reasonableness test in the Class Order. • It would be helpful if ASIC could give guidance around exactly how far you need to go in reasonably estimating indirect costs (for example, how many structures do you need to look through, how much money do you need to

		spend on investigations, etc).
		• Specifically, ASIC should clarify in the guidance exactly what is meant by "reasonable estimates", to ensure the terminology is not so relaxed that some funds avoid reporting (as appears to have occurred in the past).
		• Guidance around what is meant by "reasonable estimates" is also important in relation to the reporting of performance fees, for example how far down do you need to drill for underlying fund of fund expenses?
		• It would be helpful if ASIC could give guidance around
		  o what happens if a fund manager refuses to give the information requested by the Trustee;
		  o Is there a materiality threshold which is relevant in relation to the estimation of underlying fees and costs?
		• ASIC should also clarify whether compliance with a set of clear principles leads to the Trustee having a safe harbour in relation to its compliance with the Class Order.

Updating indirect cost disclosures	RG97.35 states that: *"The product issuer may need to consider updating the indirect costs disclosed once the actual indirect costs become known if they differ from the disclosed estimate of the indirect costs. It would be reasonable to update the disclosure of indirect costs using the known costs if these known costs are considered to be a better estimate of what will be payable in the future."* There is a considerable cost to the fund for updating disclosures across all collateral, and the shorter PDS would have to be reissued. It would be useful to have some kind of materiality guide for updating cost disclosures. In addition we note that it can be difficult to estimate accurately the costs which will be payable in the future, aside from what has been paid over the prior year, due to the timing differences of what is estimated, reversed and restated from quarter to quarter (for example, with payment of performance fees). This is administratively difficult to track and follow.	
	• **B1Q5** Do you agree that it would be a matter of good practice for trustees and responsible entities to document their procedures for making reasonable estimates as a means of enhancing consistency?	• Yes, we agree that documentation of procedures would be good practice. • However, as noted above, further guidance in relation to the level of detail required would be helpful because the approaches that underlying fund managers take to estimating their fees varies considerably between managers. • In this regard, there are significant differences between industry standard practices, valuation principles and reporting requirements, depending on the jurisdiction in which the underlying fund is based.
Trusts, Interposed vehicles and alternative fee arrangement s (such as	In reference to RG97.44-45, which requires inclusion of alternative arrangements such as securities lending in cost disclosures, while this is relatively easy for funds with direct mandates, it is more difficult to ascertain from interposed vehicles and pooled trust vehicles, yet these practices also take place at these entities. It could be assumed from the guidance that it is referring to the Trustee itself making the arrangements with its service providers, and not through other (eg. Interposed) entities.	

securities lending)		
Over the counter derivatives costs	• **B1Q6** Do you consider the guidance and examples sufficient to understand the appropriate treatment of buy/sell spreads of OTC derivatives for superannuation and managed investment products?	• We would appreciate if ASIC could give guidance on what Trustees are required to do if the buy-sell spreads are not known (or readily ascertainable)? • We are also concerned over the different treatment of Managed Investment Schemes (MIS) and Superannuation products, where hedging costs are exempt for MIS, but not for Super products.
Inclusion of additional voluntary information	• **B1Q8** Do you consider this guidance to be appropriate?	• Yes, the draft guidance seems appropriate. • However, we are mindful of the need to ensure that any additional voluntary information is presented proportionately to the existing required disclosures so as not to be confusing for members.
Fee rebates	• Rebates are referred to in a couple of different parts of RG97, and there is a fundamental issue that fee rebates tend to be applied at different structural levels. • We therefore think that further guidance needs to be given in relation to how fee rebates need to be disclosed, with the overall aim of requiring disclosure of the net fee that applies to the management of the underlying investment. • It would be helpful if AISC could provide an example to show how the Class Order is intended to apply in relation to a fee rebate scenario. • Suggested scenarios are: o Manager X has administration, responsible entity and custody fees applied within the product level, so the trustee indirectly pays a share of these standard management and administration fees within the product structure. However, each client has separately negotiated fees, which are applied outside these pooled product vehicles and paid directly to the underlying manager. o Manager Y –standard fees apply within the trust product, however the Trustee receives a monthly fee rebate in additional units on a set monthly date to net down to agreed negotiated fee scales.	
Performance fees	• **B1Q9** Do you consider this guidance to be appropriate? • **B1Q10** Are there scenarios that	Cbus believes that further details are required in relation to the inclusion of performance fees in the ICR. In particular: <u>Carried Interest vs Performance Fees</u> • Performance fees are often confused with "*carried interest*"[5], and the extent to which "carried interest" is required to be included in the ICR should be clarified.

[5] "Carried interest" is a percentage of a private fund's profits that individuals get to keep (as a return on their "investment"), and is a significant component of private equity compensation. It is distinguishable from management/performance fees which are paid to a fund manager. Carry typically averages about 20% of the fund's overall profit (although there are many variants), and is quite deliberately (often for tax reasons) *not* categorised as a performance fee. Performance fees are normally paid to the fund manager, while carry is paid (ultimately) to individuals. It is therefore unclear how carry should be categorised as for ICR

		you consider it would be appropriate to give further guidance on?	• Otherwise there is potential for international private equity funds (which typically use carried interests as their principle mechanism for remuneration) to be treated more favourably than hedge funds (which typically use performance fees as their principle remuneration) from an ICR standpoint. Using "reasonable grounds" to estimate performance fees • The circumstances in which the Trustee is required to use "reasonable grounds" to determine a performance fee should be clarified. • Ideally, a Trustee should only be required to include performance fees in the ICR when actually invoiced by the underling manager and/or paid. • This is because performance fees are typically only calculated in respect of full year periods (ie the amount of the performance fee can only be calculated once the number of assets sold in the year is known). In practice, performance fee costs are typically only captured in the following year, so there may be a six month time lag (particularly for unlisted assets but listed asset costs are generally captured in the most relevant reporting period). • If it is now intended that Trustees need to reasonably estimate (or require an underlying fund manager to reasonably estimate) a performance fee in relation to the period for which a performance fee may have accrued but is not yet payable, this could lead to considerable uncertainty, and there is significant potential for inconsistent approaches. • For example, where the financial years of the underlying fund and the superannuation product are not aligned, it will be difficult to provide an estimate of the performance fee. This is because clawbacks may result in fees that have accrued being reversed out in later periods – resulting in a much lower fee the following year due to the reversal. • By contrast, if performance fees are only incorporated to the extent they are invoiced by the fund manager, it may be simpler and easier to reconcile the amount in the underlying manager's fund accounts, and simpler for tracking purposes. • Making an assessment on 'reasonable fees' may be difficult (i.e. short term performance can be very positive) and may not be consistent with the longer term timeframe for which performance fees are measured and paid, for example if paid on rolling 3 year performance, the underlying manager can still be recouping past losses. Other examples • Other examples of how capturing "accrued performance fees" may be difficult to achieve in practice are set out below: • If the market environment is very volatile and the underlying product has high performance fees, this could lead to large variations in performance fee accrual reissues and confusion as to what should be captured and when, which will be difficult to track. One underlying manager's way to deal with this issue is to have a refundable performance fee

purposes. Is it a fee paid to the management, or is it simply an investment return paid to individuals in their capacity as investors in the fund?

		reserve, where only a portion of this excess outperformance is paid, due to the underlying volatility. Hence capturing all the accrued performance fees can lead to material upward and downward swings that are not necessarily consistent with what is paid. • Inconsistency of reporting performance fees where the underlying assets are held for a very long time i.e. infrastructure assets where performance fees are crystallised generally when the underlying assets are sold. If the investment environment is volatile, this potential performance fee accrued can be very large and when the market environment becomes more risk adverse, there can then be a sudden large negative performance fee accrual. Yet the performance fee isn't expected to be paid until the underlying asset is sold (which can be many years later, in a more positive environment). • There is also a potentially long lag post reporting period for unlisted assets i.e. private equity can take up to 180 days for an update and could take even longer for reviewing all underlying fund reporting. • If the underlying product is very complex, i.e. hedge fund investments, there can be volatility in the underlying performance fee accruals, and confusion as to what should be captured and when, which will be difficult to track as these can be very different for different underlying tactical strategies. This can also be very different to the agreed performance fee payable at the top level. • Another example is buying a secondary private equity investment at a discount - this accrued performance fee can be difficult to calculate and track with limited look through access as sometimes this indirect accrued performance fee may be included within the underlying asset price, indirectly factored in the discount multiple of the book value price, sometimes offset against the yield etc. Some underlying managers may hold hundreds of these underlying investments. This means it depends on the underlying manager's process, resources and reporting methodology. • The underlying issue relates to the use of discount 'net' cash flows - that is, cash flows after deducting the management and performance fees of the underlying funds can differ to the estimated top level fund manager fees on the capital value they propose to invest. Since the price that the top level fund manager offers to focus on is the return hurdle on net cash flows, it can be assumed that the seller (not necessarily the top level fund manager) bears the cost of the present value of future management and performance fees. Consequently, some fund managers do not track the amount of carry that may or may not be applied to the distributions that are received, which can be over 500 distributions per calendar year. • The distribution notices received from the underlying general partners do not provide information concerning the amount of carried interest paid, nor does the top level fund manager have information to reasonably estimate these amounts. In an attempt to estimate carried interest, the top level fund manager may look at the K-1s to see the annual long term capital gains and apply a broad 20% carried interest assumption. However, this practice can significantly

		overstate the carried interest because it ignores any management fee offset, preferred return hurdle or previous fund losses offsets that may need to be recouped. Further, other underlying investments may have zero or tiered carry.
Past fees versus prospective fees, and the ICR	There is an area of conflict between the commentary on performance fees and the commentary on indirect cost ratio – see RG 97.91: *The product issuer should use the fees and costs from the financial year before the PDS is issued to determine the indirect cost ratio at the time the PDS is issued. Typically, this will be cost information from the last financial year ended before the issue of the PDS.* The performance fees from fund managers and interposed vehicles are captured for many funds in the Indirect Cost Ratio, and the practice generally is to show the fees and costs from the financial year before the PDS is issued. It is confusing to understand in this environment how to bring in prospective performance fee disclosure where it is incorporated into the ICR.	
Insurance Disclosure	• **B1Q11** Do you consider this guidance to be appropriate? • **B1Q12** Do you recommend any other guidance that should be included to further assist industry in this area?	• We support in general terms the idea of guidance being given in relation to the disclosure of information around insurance costs to enable comparative between offerings. We encourage the included disclosure of commissions, loadings and rebates to identify the total costs. • The directive to present age based cover in a consistent format however may be more appropriate placed within the Corporations Regulations. • We also believe that further consultation on insurance disclosures would be useful.