From: Luke Barrett …
To: Maan Beydoun <Maan.Beydoun@asic.gov.au>,
Cc: …
Date: 05/05/2015 06:08 PM
Subject: RE: Soft Consultation - Draft amendments to Class Order 14/1252

Dear Maan

Thank you for your email below and for time you made available on 1 May 2015 to discuss this by telephone.

You will see that I have cc'd Michelle Levy who has succeeded Pam in the role of Chair of the Law Council's Superannuation Committee, and I am now its Deputy Chair.

The Law Council appreciates the opportunity to participate in soft consultations such as these and is always pleased to provide input and drafting guidance where it can.

Our comments focus on the following three aspects of the proposed modifications to the extent they impact superannuation funds:

1. Fixing the 'double-counting' issue concerning ICR and investment fee disclosure;
2. Interposed vehicles; and
3. Costs of OTC derivatives.

As a general drafting comment, we suggest that ASIC re-issue the existing class order in its entirety (with the desired changes included) rather than issuing piece-meal modifications which practitioners would have to manually integrate into the class order.

Fixing the double-counting issue

There is in an error in the Corporations Regulations insofar as the concepts of 'indirect cost' (and therefore ICR) and 'investment fee' overlap. Industry requires clarification as to whether investment-related amounts must be disclosed twice (i.e. as part of both the ICR and the investment fee) or whether it is sufficient to include investment-related amounts in one or the other.

The definition of 'investment fee' (cl 209A of Schedule 10) reflects the definition that appears in section 29V of the SIS Act. The definition used in the SIS Act is necessarily broad and includes amounts which are not actually fees – for example, costs incurred by trustees which are not actually deducted from member accounts in the form of specific fees. The definition used in the SIS Act needed to be broad, because members invested in MySuper products cannot be charged amounts which are not caught by any of the fee categories defined in section 29V of the SIS Act. There is no overlap or double-counting issue in the SIS Act, because the SIS Act makes no reference to ICRs. As such, there is no problem with the definition used in the SIS Act.

However, an error was made when inserting the same definition of 'investment fee' in Schedule 10 of the Corporations Regulations. It was apparently overlooked that the definition of investment fee overlapped with the existing concepts of indirect cost and ICR.

Industry was hoping that class order 14/1252 would fix the anomaly by changing the definition of 'indirect cost', but it did not. The problem is notional section 101A(1)(c), highlighted below.

> ***101A Indirect costs***
>
> *(1) Despite subsection 1013C(2) of the Act, the indirect cost of a MySuper product, an investment option offered within a superannuation product other than a MySuper product, managed investment product or investment option offered by a managed investment scheme means any amount that:*

(a) a trustee of the entity or responsible entity knows, or reasonably ought to know or, where this is not the case, may reasonably estimate, will directly or indirectly reduce the return on the product or option that is paid from or reduces the amount or value of:

(i) the income of or the property attributable to the product or option; or

(ii) the income of or property attributable to an interposed vehicle in or through which the property attributable to the product or option is invested; and

(b) is not charged to a member as a fee; and

(c) is not a fee under section 29V of the SIS Act.

The definition of 'investment fee' which is used in section 29V of the SIS Act is so broad, for the reasons indicated above, that it encompasses almost all investment-related amounts (as does the definition which is replicated in cl 209A of Schedule 10 of the Corporations Regulations).

As such, in effect, there would be almost no investment-related amounts left to include in the ICR, except for amounts incurred via interposed vehicles. CO 14/1252 potentially renders the ICR concept redundant, which we assume was unintended by forcing the migration of amounts away from ICR and into investment fees. This is not the position under the existing law. Whereas the existing definition of 'indirect cost' which appears in cl 101 of Schedule 10 carves out amounts which are "charged to the member as a fee", this does not address the double-counting issue because the definition fails to carve out amounts which are disclosed as fees (i.e. amounts which are disclosed as fees because they are caught by the definition of 'investment fee', even though they are not actually fees in the traditional sense).

One might question – why does it matter whether an amount is disclosed as an 'investment fee' or as part of the ICR? It matters because trustees have control of the fees (i.e. fees in the traditional sense) that they will charge members in the future, but they have no control over the costs which they will incur and pay to third parties in future. This is why investment fees can be set and disclosed prospectively and stated with certainty. However, costs paid to third parties (e.g. paid to external investment managers) cannot be guaranteed into the future. This is why the law has traditionally allowed the ICR to be published for the most recently completed financial year, and superannuation funds make it clear that costs in future years may be higher or lower.

If investment costs will be migrated en masse to the 'investment fee' category, that whole category of fee will no longer be able to be stated with certainty. This will detract from the certainty which currently attaches to investment fees. Whereas under the traditional law investment fees are effectively guaranteed, under the new provisions this would no longer be the case. This change would create issues of estimation for funds, which would have to make predictions about the future which they are not currently required to make.

Funds would have to include footnotes and disclaimers under their PDS fee tables to make it clear that the investment fees are merely estimates and could be higher or lower – in other words, investment fees would be subject to the same disclaimers and footnotes which apply to ICRs. Members will see this and may wonder why investment-related amounts have been split between investment fees and ICRs. The distinction makes sense when investment fees are things which are actually charged as fees and when the ICR is everything else.

This creates a further issue under section 1017B of the Corporations Act, which requires at least 30 days' advance notice to be given before an increase in fees. If investment fees start to be disclosed on an estimated basis, many funds will find themselves in breach of section 1017B if actual costs paid to third parties cause the actual amount of investment fees to be higher than the estimate disclosed in the PDS. This is something which will often only be known after the event, long after the time for providing 30 days' advance notice has expired.

Proposed solution

For all these reasons, it would appear appropriate for ASIC to fix the double-counting issue by allowing funds to continue including investment-related costs in their ICRs. Investment-related amounts which are actually charged to members as fees could be disclosed as 'investment fees'.

To achieve this, we would recommend:

- The following change to notional section 101A:

101A Indirect costs

(1) Despite subsection 1013C(2) of the Act, the indirect cost of a MySuper product, an investment option offered within a superannuation product other than a MySuper product, managed investment product or investment option offered by a managed investment scheme means any amount that:

(a) a trustee of the entity or responsible entity knows, or reasonably ought to know or, where this is not the case, may reasonably estimate, will directly or indirectly reduce the return on the product or option that is paid from or reduces the amount or value of:

(i) the income of or the property attributable to the product or option; or

(ii) the income of or property attributable to an interposed vehicle in or through which the property attributable to the product or option is invested; and

(b) is not charged to a member as a fee.~~; and~~

~~*(c) is not a fee under section 29V of the SIS Act.*~~

- The following change to the definition of ‘investment fee’ which appears in cl 209A of Schedule 10:

*An **investment fee** is a fee that relates to the investment of the assets of a superannuation entity and includes <u>the following but only to the extent that they are charged to members as a fee</u>:*

(a) fees in payment for the exercise of care and expertise in the investment of those assets (including performance fees); and

(b) costs incurred by the trustee [OR the trustees] of the entity that:

(i) relate to the investment of assets of the entity; and

(ii) are not otherwise charged as an administration fee, a buy-sell spread, a switching fee, an exit fee, an activity fee, an advice fee or an insurance fee.

Interposed vehicles

We reviewed the revised definition of ‘interposed vehicle’ with much interest and are appreciative of the effort to address several of the issues identified in earlier consultations and submissions.

It is certainly a slippery concept which is perhaps easier to understand in an abstract sense, but difficult to put into words. The proposed definition is quite technical. While we can see the logic underpinning the proposed new definition, we see the following difficulties and challenges.

- Many aspects of the proposed new definition focus on whether or not more than 50% of an entity’s assets are invested in a particular way. On the one hand, we see the logic in focussing on how the majority of an entity’s assets have been invested, and in having some precision in what the materiality threshold is. However, large superannuation funds invest in a large number of entities – some may invest in over 15,000 different companies, for example. In practical terms, funds will simply not have access to information which would allow them to determine in an accurate way whether the test is satisfied. If ASIC were to adopt this type of information, we suspect many funds would take an educated guess or make an educated assumption whether the test had been fulfilled and we query how ASIC would monitor compliance.

- Many aspects of the proposed new definition focus on what is said in a fund’s PDS. Again, given the large number of entities invested in, this will make it very cumbersome (or impossible) for funds to include the relevant disclosures in their PDS in order for vehicles to qualify for the appropriate treatment.

- In determining whether an entity is an interposed vehicle, holdings which confer control over an asset are ignored (see the definition of “restricted securities). However, as discussed, this overlooks the situation where an entity may have invested (say) 100% of its assets in a minority stake (say 40%) of an asset.

Proposed solution

Stepping back, and based on our discussions, it seems that the policy intention is (roughly speaking):

- To ensure that costs in the nature of investment management fees incurred within pooled vehicles are brought to account via the ICR; and
- To clarify that operational expenses (i.e. everything other than investment management fees, such as salaries, wages, insurance premiums, audit costs) are not caught up in the definition of ICR.

The difficulty is that even businesses which are not involved in the investment industry make investments – for example, companies like BHP Billiton hold shares in a wide range of companies and own mines and real property and so forth.

Perhaps there is merit in avoiding an approach which focusses on whether or not investments are made. Instead, perhaps the focus should be on whether the entity has effectively been invested in for its ability to manage portfolios on a discretionary basis.

For example, perhaps an interposed vehicle could be defined as any entity in relation to which each of the following criteria is fulfilled:

(a) The entity holds or manages on a discretionary basis a portfolio of securities which was acquired using funds which were originally contributed to by investors;
(b) Holders of securities in the entity stand to directly benefit from the returns of the portfolio(s) (there is potential for this aspect of the definition to reflect the drafting of section 1012IA; specifically, para (c) of the definition of ‘custodial arrangement’); and
(c) The entity requires (or ought reasonably be assumed to require) an AFSL with a dealing authorisation to hold and manage the portfolio(s), or would be required to hold one if their activities were conducted within Australia.

Companies like BHP Billiton and Rio Tinto would not be caught because they do not hold an AFSL and do not manage discretionary portfolios (even though they may hold securities in other entities as part of their ordinary business). ETFs and LICs would be caught and their costs would have to be included in ICRs. On the other hand, financial conglomerates like CBA and Westpac would not be caught because, even though they may have AFSLs and manage portfolios for their clients, shareholders do not directly benefit from the returns on those portfolios.

In addition, it would be helpful to clarify that in no instances are operational expenses required to be included in ICRs (i.e. exclude everything other than investment management fees, such as salaries, wages, insurance premiums, audit costs).

Costs of OTC derivatives

Our understanding is that ASIC is concerned that some funds may be able to publish low investment fees and low ICRs by using derivatives to create synthetic exposures rather than physical holdings of securities.

For example, a fund may enter into a total return swap, or enter into an arrangement (or possibly invest into a vehicle which has made arrangements) whereby some index return is guaranteed by a third party who does not impose any fees or charges. In these scenarios, the third party may make its money - not by charging fees – but instead by making other investments and hoping that the returns from those investments will exceed the return which it has guaranteed to provide.

The practical reality is that there are no direct fees or charges in using OTC derivatives in this way.

We refer to our prior written submission which explains in some detail why, in the OTC space, there are no visible buy-sell spreads and the difficulties which would arise in trying to track this information and integrate it within ICRs.

We query whether it is the right approach to create an artificial or fictitious concept of a buy-sell spread in order to attribute some cost to OTC derivatives which does not exist in practical terms.

One may question why all funds do not do the same – i.e. why more funds do not make use of synthetic exposures. The answer is that there are various downsides to using derivatives. For example:

- derivatives lead to increased counterparty risk – even if a particular OTC trade turns out to be profitable, the superannuation fund is dependent upon the counterparty being solvent enough to pay what has been promised;
- funding collateral calls can be logistically challenging and can potentially require quick access to substantial liquidity at short notice, which may not be feasible for some superannuation funds; and
- synthetic exposures may not simulate dividend returns (e.g. they potentially only capture movements in share prices).

We query whether an alternative approach would be to require funds to disclose the extent to which they utilise derivatives and give greater prominence to the risks which arise from doing so.

Finally, we note an inconsistency within the architecture of the class order. Given the current drafting, most amounts would technically cease being part of the ICR and would instead become part of a fund's investment fee. As such, costs of OTC derivatives would technically have to be included within investment fees. However, notional section 101A(3) suggests that these amounts form part of a fund's ICR. In other words, the class order is creating a new double-counting issue. However, our proposed solution set out above would address this.

If you have any further queries, please let me know.

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