Individual Submission to ASIC

Proposed Changes to Fee Disclosure

Thank you for the opportunity to comment on the proposed changes to fee disclosure. The proposed changes are quite detailed.

However it is not clear to me whether the proposed changes will enable members of super funds and investors in managed funds to clearly identify what I consider to be the most relevant cost: the cost that the fiduciary agent extracts for its role as acting as fiduciary agent along with the amounts that are paid to parties related to the fiduciary agent. It is possible that this is captured in the new definition of Indirect Costs and, if so, then this is not clear and should be stated more explicitly.

To provide more background to this issue I provide the following comments.

1. Fee Disclosure

Current fee disclosure acts as a barrier to fiduciary agents acting in the best interests of their investors. Tacitly it is also encouraging investment strategies that will become increasingly concentrated in a narrow range of strategies, such as passive investment in publicly traded securities. The concentration of strategies introduces systemic risks to Australians' retirement savings as well as the economy. At the same time, other investment opportunities that could enhance retirement outcomes and the broader economy will be starved of capital

As part of its fiduciary role, an RSE or RE is responsible for a number of tasks. In return for taking on this fiduciary role, the RSE or RE is entitled to extract payment for its services. However, the current fee disclosure rules, which bundle fees together, mean that investors are not told the fee that is being extracted to act in this fiduciary capacity. As a result, there is a lack of transparency at this fundamental fiduciary level and it is unclear that the proposed changes to fee disclosure will explicitly identify this fundamental fee. There is also no clear pressure for RSEs to become more efficient.

In exercising fiduciary responsibilities, it is important to spend investors' money wisely in the search for investment returns. However, there are a number of potential issues that can compromise the ability to act in the best interest of investors.

To take one example, an important role is to identify and exploit investment opportunities. An RSE or RE may take a view that there is an opportunity to extract returns by lending money to households or businesses. This could be implemented in a number of ways, some of which may include investment management costs and some others that may involve a third-party guarantee by a bank or other highly rated organisation.

Faced with the complexity of direct lending, the RSE or RE might simply lend money to a bank which then on-lends the money to underlying borrowers. The fund would then receive an interest rate after the bank on-lends the money and extracts an interest margin.

Now suppose that a direct lending program can be implemented, with appropriate guarantees, at an average interest rate of 6% pa before costs and 5% pa after deducting costs. At the same time, the interest rate being offered by a bank is 2% pa; with the "fee" that is represented by the bank's interest rate margin being unknown.

The direct lending program has an expected net return of 5% pa after a 1% explicit fee; the lending to the bank has an expected net return of 2% pa after an unknown implicit fee. However, by pursuing the higher net return, the RSE or RE risks being seen as uncompetitive in terms of fees even though the RSE or RE itself may not be receiving any additional fee for its own account. The RSE or RE is discouraged from even considering such disintermediation.

An issue raised in the Royal Commission's public hearings was the extent to which RSEs of superannuation funds do or do not invest in unlisted assets, which typically incur higher management fees.

Acting in the best interests of its members, one RSE could take a view that unlisted assets are a good investment opportunity.

Another RSE might take a view that unlisted assets are currently valued too highly and will not deliver an acceptable future return. This RSE might assess that passively managed listed shares, which incur lower investment management fees, offer better prospective returns. For such an RSE, this would be a legitimate basis on which to prefer listed investments over unlisted. Under current fee disclosure practice, an ancillary benefit for such an RSE would be an improvement in its profit margin or what appears to be more competitive fees. This raises an obvious conflict.

Members of a superannuation fund should want their RSE to be making

investment decisions on the basis of outcomes that are relevant for the members; not the profit margin that the RSE is able to extract or the third-party costs that the RSE expects will add value for its members. Fees that an RSE pays to unrelated third-parties are effectively a cost of doing business and should be treated as such in fee disclosure. This appears to be an objective of the proposed approach to disclosing the cost of the product as a separate item but, again, this is not clear. And it may lose sight of the extent to which an RSE simply shifts profit within its group in a way that makes it look cheaper when it is in fact more expensive in terms of the fee it extracts for itself and related parties.

In fact, the ability of an RSE to access unlisted investments and negotiate terms is likely to be much better than members can do as individuals and, in some cases, such opportunities would not be available at all to an individual. Classing amounts paid to unrelated third parties to manage these investments as "fees" masks and distorts what might actually represent a saving for members compared to what they could do themselves.

Similarly, spending money on external tax or legal advice might add significantly to net returns but the additional cost could increase reported costs.

There are many more examples in which fee disclosure can discourage activity that would both improve retirement outcomes and make the economy more efficient.

Specifically:

- Vertical integration may bring undue pressure to use related party service providers.
- Choice of investment implementation can be compromised by different disclosure treatments of costs – for example remuneration to those who operate a listed company typically is not classed as a fee whereas remuneration to those who operate an unlisted hedge fund would be regarded as a fee.
- Superannuation fund members and investors in managed funds have fiduciary agents but are not informed what their agents are charging to provide the fiduciary services.

These compromises apply to all funds. Indeed, as industry superannuation funds become more and more vertically integrated they are likely, eventually, to face some of the same conflicts that are faced currently by the commercial funds.

One potential response to this issue of fee disclosure is to "look through all costs", a concept that is embodied to some extent by the RG97 fee disclosure rules.

However, whenever money flows in the economy there is a potential for a proportion of that flow to be extracted as a payment. Such payments can take a variety of names including profit share, margin, brokerage, surcharge, bonus, wage, salary, tax, commission, rent, interest, carry, rebate, loading, disbursement, duty, royalty, rates and probably many more. They all are effectively some type of fee and are an implicit cost of doing business; but trying to identify every single one is impossible.

In order to make the industry more competitive and to allow RSEs to concentrate more fully on net returns to members, fee disclosure should take the following form. These costs should be readily identifiable as part of the preparation of Business Activity Statements for GST calculations:

- Identify the costs being added and charged by the RSE or RE to undertake its role as a fiduciary agent
- Identify fees and other payments to related third parties and require the RSE or RE to ensure that these are fair and reasonable, with assistance of the survey to which reference is made in the following Point 2.
- Payments to unrelated third parties should be competitive but should NOT be the primary focus for fee disclosure, as the only reason to employ such third parties should be to pursue higher net returns for members. Such "fees" may represent the replacement of an implicit fee with a lower explicit fee and, in the interests of efficiency, should be encouraged.

Once this is done there will be a clear demarcation between what an RSE or RE is charging and what is being paid to other parties on behalf of clients as a cost of doing business.

For example, there will be no undisclosed financial benefit that an RSE or RE will gain from replacing a high-fee external investment manager with a low-fee external manager – all the benefits from such action will accrue to members. By the same token, RSEs or REs will not be financially penalised if they decide to invest with a higher-fee manager if they genuinely believe that is justified by an expectation of higher net returns.

Importantly, under this approach, RSEs and REs will not be impeded from investing in a broad range of investments in the pursuit of higher net returns. They will be encouraged to identify a greater range of potential investment

opportunities and will be free to pursue the most efficient method of exploiting each of those opportunities. This will improve investment returns, improve retirement outcomes, enhance competition and make the economy more efficient.

Over time the financial system as a whole will utilise a broader opportunity set and this will reduce the systemic risk that will occur if investment strategies otherwise become increasingly concentrated

At the same time, investors will be able to see exactly what they are being charged by their fiduciary agent and this will allow competition to be more effective at this basic level.

If this approach is not implemented then the most likely outcome is that RSEs and REs will remain compromised in their selection of investment strategies and investment programs will become more and more concentrated in a narrow range of strategies, such as passive investment in listed shares and loans. This represents a serious systemic risk to Australians' retirement savings. At the same time, other investment opportunities that could enhance the broader economy will remain starved of capital.

2. Survey of Fees Paid

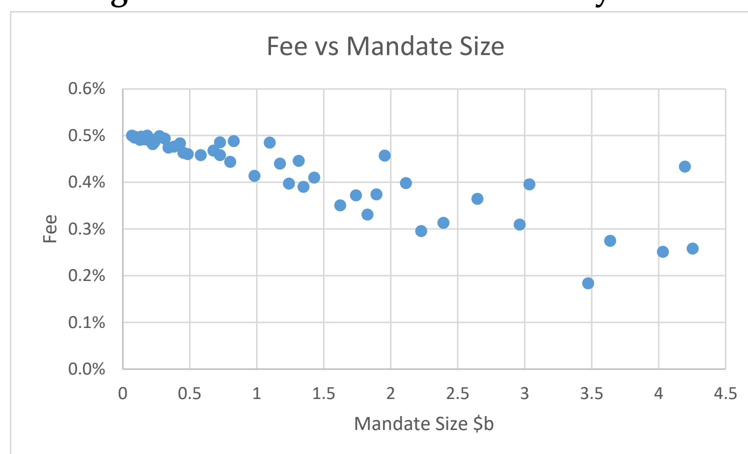
A potential problem with the fee disclosure approach described in Point 1 is that RSEs and REs may lose focus on the payments that are made to unrelated third parties. They may also lack a solid foundation against which payments to related parties can be benchmarked.

APRA and ASIC are well placed to survey fee arrangements for material outsourcing arrangements such as administration, custody and investment management. As regulators, they can do this in a way that does not compromise confidentiality agreements.

Summary information can be provided to RSEs and REs who can then compare the fees that they have negotiated with those in the market. This will also provide a basis for benchmarking relationships with related parties.

To illustrate, data for a specific type of investment mandate might be reflected in the following chart.

Figure 2: Illustration of a Fee Survey Data



An RSE or RE faced with this data may identify that the fee being paid by them on a $4.2 billion mandate is high. This outlier might be justified – for example, it may relate to a mandate with a zero base fee and the total fee reflects a share of exceptional outperformance.

Conversely, it is also possible that the fee had not been renegotiated for some time and had become uncompetitive. The RSE or RE would have to make a decision as to whether or not that particular manager warranted a premium fee. If the high fee was being paid to a related party then it might be an

indication that the arrangement, in its current form, needs to be renegotiated to ensure it remains in the interest of investors.

Similar like-for-like comparisons could be completed for administration, custody, brokerage and other material activities. For example, brokerage rates might be compared against market impact, the volume of trading and nature of the mandates. Administration costs could be compared to the number of members, assets under management or average account balance. Custody costs are likely to vary by the size of assets, complexity of investment arrangements and range of services

By making fees more transparent as described in Point 1, there will be downward competitive pressure on the fees that RSEs and REs charge for acting in their fiduciary roles. Providing information such as described in this Point 2 will provide competitive pressure on the fees being paid to unrelated third parties and will also provide a solid benchmark for RSEs and REs to assess their arrangements with related third parties.

In combination, a number of potential conflicts will be removed or mitigated. There will be downward pressure on all fees. RSEs and REs will also have the incentive to identify and exploit investment opportunities in ways that disintermediate those established players who are charging excessive fees. This will improve investment returns and retirement outcomes and will also make the economy more efficient.