Law Council
OF AUSTRALIA

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Dear Mr Beydoun

Review of Regulatory Guide 97 – Disclosing fees and costs in PDSs and periodic statements

I am pleased to enclose a submission prepared by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia.

The Committee would welcome the opportunity to discuss the submission further. In the first instance, please contact:

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Yours faithfully

MARTYN HAGAN
SECRETARY-GENERAL

Law Council
OF AUSTRALIA

Review of Regulatory Guide 97: Disclosing fees and costs in PDSs and periodic statements

Australian Securities & Investments Commission

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Executive Summary

This submission has been prepared for the Law Council of Australia by the Superannuation Committee of the Legal Practice Section. It deals primarily with questions related to superannuation product disclosures.

The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. The Committee makes submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

The Law Council of Australia is the peak national representative body of the Australian legal profession and represents some 60,000 legal practitioners nationwide. **Attachment A** outlines further details in this regard.

The submission responds to the numbering in the paper accompanying draft *Regulatory Guide 97*.

Issues with the 'double-counting' fix

Class Order 14/1252 purports to address the so-called 'double-counting issue' whereby, under the Corporations Regulations, some charges potentially need to be disclosed as both investment fees and also as part of the Indirect Cost Ratio (ICR).

Previously the Australian Securities and Investment Commission (ASIC) granted issuers flexibility to choose how to disclose these amounts. On one reading of the class order, the concept of ICR could be rendered completely redundant and obsolete for many funds, as they will potentially be required to migrate all charges from the ICR category across to the investment fee category. However, there is another interpretation (which is also open on the wording) which would have a more measured impact.

RG 97 should address this issue squarely as it potentially represents a fundamental change in approach to setting and disclosing charges. If a paradigm change is indeed intended, greater publicity around the issue is probably needed to ensure that all of industry is aware of the magnitude of the change.

Interposed vehicle

The examples illustrating what does and does not constitute an 'interposed vehicle' are helpful, given how complex the drafting of the class order is, although in each case it would be useful to include the reason for ASIC's conclusion. (Note that Example 5 includes an error which we have pointed out below.)

Further guidance is required around the use of special purpose project vehicles to hold real property and infrastructure assets. In these cases, it seems sensible to adopt a 'bundling approach' so that an investment in a special purpose vehicle can be treated as an end investment even though it is known from the outset that it is merely a conduit to the actual, underlying property and infrastructure asset.

Further guidance would also be useful about the terms of the two end investment exceptions. It is quite difficult to discern from the Guide that there are two different exceptions. It would also be useful to include a discussion about when a body, trust or partnership does or does not predominantly carry on a business of investment in securities or other financial products for the purposes of the first exception.

RG 97 might be interpreted as setting a higher bar for a body, trust or partnership to qualify for the first end investment exception than is required by the class order. The first exemption in the class order focuses on whether it is reasonable to regard an investment as an end investment. RG 97 suggests that the Product Disclosure Statement (PDS) must name the particular investment vehicle. Naming the investment vehicle in the PDS could be one way that it might be reasonable to regard the investment vehicle as the end investment under the exemption, but not the only way.

Requirement to reasonably estimate costs

ASIC's guidance would be more helpful if it pointed to the exact sources of information that may assist trustees in estimating costs.

RG 97 suggests that ICRs must include forward-looking estimates of indirect costs in the future, which is generally not the case. The ICR is inherently a backward looking figure which reflects indirect costs in the most recently completed financial year.

Estimates are only needed to the extent that an issuer does not have precise data about costs in the previous financial year when preparing the PDS.

Over-the-Counter (OTC) derivative buy-sell spreads

We remain concerned that an unintended consequence of the Stronger Super reforms was to include transaction costs in ICRs for superannuation products but not for registered schemes.

In practical terms it will be difficult for trustees to comply with this requirement, particularly in the case of Over-the-Counter (OTC) derivatives. In many cases there will be no visible buy-sell spread for OTC derivatives. A particular OTC derivative might only be priced when a trustee confidentially approaches a counterparty with a view to entering into the trade. When this happens, only that particular trade will be priced and there may be no data available to determine how the reverse trade would have been priced.

A question also arises as to how the buy-sell spread should be allocated if the relevant position has a tenor which straddles two or more financial years.

It is unclear whether buy-sell spreads on exchange traded derivatives should be included in the ICR pursuant to the general definition of indirect costs. As a policy matter we do not think they should be. These are not costs, but simply the mathematical difference between what someone is willing to sell for and what someone else is willing to pay. This amount is not charged, making it qualitatively different from the buy-spreads and sell-spreads which are charged by managed funds to an investor when investing or withdrawing from a product.

Inclusion of revenue sharing in ICR

The suggestion that income sharing arrangements should be included when calculating ICRs will potentially come as a surprise to some product issuers and could be seen as contentious. We encourage ASIC to raise the profile of this issue to ensure that a consistent approach towards compliance is taken.

Inclusion of additional voluntary information

We are not sure that ASIC's suggestion for related party payments to be disclosed as component parts of a fee would necessarily assist in managing conflicts of interest, particularly in a superannuation context where disclosure alone is unlikely to be sufficient to satisfy the requirement in section 52(2)(d) of the *Superannuation Industry (Supervision) Act 1993* to ensure that any conflict does not adversely affect the beneficiaries' interests.

Performance fees

We are concerned that RG 97 adopts an oversimplified approach to the disclosure of performance fees. We advocate for a more nuanced approach, which acknowledges the different ways in which performance fees can be levied.

Where the product issuer levies the performance fee, it could potentially be disclosed as an investment fee on a forward-looking basis. However, where the performance fees are levied by numerous external investment managers, they would more typically be included in the ICR, meaning that the calculation must be based on historical performance fees for the previous financial year.

In our view RG 97 should recognise that there may be no simple or uniform way of disclosing performance fees applying in the future, especially where performance fee arrangements have been entered into with a large number of external investment managers, in a range of asset classes, all with different rates, benchmarks, hurdles, fee caps and claw back arrangements.

Publishing the highest fee rate will often be misleading, especially since performance fees can be highest for alternative assets which, by their nature, are 'alternative' meaning that only a small proportion of a product's assets are invested in them. The bulk of a product's assets may be invested in orthodox asset classes, which have more favourable performance fee arrangements. While a weighted average may appear to be a solution to this particular issue, even this would involve making an assumption as to what the future performance of each asset class will be.

On balance, there seems to be reasonable weight to the argument that disclosing the previous year's performance fees (as a percentage, not a lump sum dollar amount) provides a meaningful indication of how significant (or not) performance fees have been in the recent past.

Insurance disclosure

It may be difficult for occupational loadings to be disclosed in a PDS, because they may be imposed by an insurer as part of the underwriting process and therefore not known at the time a PDS is prepared.

Interaction with periodic statements

Under the new concept of 'indirect costs', if an administration fee or an investment fee is charged by way of a percentage deduction from returns (rather than deduction from the member's account) it would not be included as part of the Indirect Costs Ratio (to prevent double counting).

However, if percentage-based fees are not included under item 301(1) of Schedule 10 of the *Corporations Regulations 2001* as indirect costs, there might be no disclosure of these amounts on a periodic statement.

Fees that are deducted directly from member's accounts are reported in a periodic statement in dollars as a transaction cost, but the industry practice is **not** to list percentage based fees as transaction costs (or to convert them to dollars) because they are currently counted as part of the ICR). Going forward, if ASIC takes the view that these percentage-based fees will need to be disclosed in dollars as transaction costs, then it would be useful for guidance to be given to the industry earlier rather than later – because trustees will neede to chang their periodic statement templates (which are system-based).

Comments on RG97

Issues with the 'double-counting' fix

1. Class Order 14/1252 purports to address the so-called 'double-counting issue' whereby, under the Corporations Regulations, some charges potentially need to be disclosed as both investment fees and also as part of the ICR. Previously ASIC had provided guidance that it was sufficient for issuers to choose whether to disclose these amounts as investment fees or whether to categorise them as part of the ICR (but not both). This was a pragmatic approach that afforded flexibility to issuers.

2. However, notional section 101A under the class order defines an indirect cost as being an amount which, amongst other things, 'is not charged to the member as a fee' and 'is not a fee under section 29V' of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act).

3. We agree with the first proviso: an amount which is separately charged as a fee (in the usual sense) should definitely not be included in the ICR.

4. However, the second proviso is potentially problematic. This is because section 29V of the SIS Act defines a fee (e.g. investment fees) as including amounts which are not actually charged as fees – such as investment costs which are incurred by the trustee. These amounts have traditionally been disclosed as part of the ICR because of the fact that they are not actually charged as fees.

5. Bear in mind that, for MySuper products, the only amounts that can be charged are those which are defined in section 29V. In an extreme case, therefore, there would be nothing to include in the ICR (i.e. because everything which is charged must, by definition, fall within the section 29V definitions).

6. We suspect this may be an unintended consequence or misinterpretation of the class order and notional section 101A(1)(c). For example, perhaps notional section 101A(1)(c) means that an amount only needs to be included in the ICR if it falls within section 29V of the SIS Act and is not charged as a fee in the usual sense (as opposed to the expanded sense adopted by section 29V).

7. RG 97 should address this issue squarely as it potentially represents a fundamental change in approach to setting and disclosing charges. For many superannuation funds this could effectively render the concept of ICR completely redundant and obsolete and will require substantial changes to systems, disclosure documentation and periodic statements.

Interposed Vehicle

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?

General comments on usefulness of guidance

8. As a general proposition, the examples are all helpful to different extents. This includes the examples in RG 97.26 – RG 97.32, as well as the case studies in Examples 1 – 8. However, we query whether some of the examples are entirely accurate. We also think that it would be useful for the examples to include the reason for falling within or outside the exception and specifically where they satisfy an exception, which limb of the exception.

9. We consider that the examples of when an entity is **not** an interposed vehicle are the most helpful in illustrating what ASIC had in mind in drafting the concept of interposed vehicle.

10. These examples are important because, according to Class Order 14/1252, everything is an interposed vehicle unless it falls within one of two exceptions – the regulated platform exception (as illustrated in example 7) or the 'end investment' exception.

11. The end investment exception is the most difficult to interpret because it has two limbs and then two alternatives within the second limb, depending on whether the entity is listed or not.

The end investment exception: business of investing in securities

12. In all cases, to be an 'end investment' the 'entity' must be one that does not predominantly carry on a business of investment in securities or other financial products. Examples 5 and 8 demonstrate this first limb. Later in this submission, we suggest that ASIC provide guidance as to how broadly this first limb may be interpreted.

13. Examples 1 – 4 are useful, but could be more closely correlated to the definition of interposed vehicle in CO 14/1252. For instance, it seems that in each of these cases, the first limb would not be met because the relevant entities *do* predominantly carry on a business of investing in securities or other financial products. This point should be emphasised in Examples 1 – 4. Otherwise there is a danger that a person reading paragraphs RG97.26 – RG97.28 and RG 97.30 alone could erroneously believe that the way a PDS describes its investment option is the sole determinant.

The end investment exception: relevance of PDS disclosure

14. More importantly, there is a mismatch between the drafting of the class order and the explanations in RG 97 as far as the second alternative under the second limb of the end investment test is concerned.

15. For the purposes of the end investment exception, under the class order, the question is whether an entity 'is reasonably regarded as the investment of the superannuation entity or registered scheme …. rather than the means by which the benefit of investments by [the entity] is obtained'.

16. However, RG 97 seems to change the test, and suggests that the question is whether the PDS ‘makes it clear to investors and potential investors that the investment they are making is in that [entity]’ – see for example, RG 97.26. Other examples then seem to focus on whether the particular investment is named in the PDS.

17. The approach adopted in RG 97 might be interpreted as setting a higher bar than is required by the class order for qualifying for the end investment exception. It will often be reasonable to regard an investment as an end investment even if the PDS does not name the particular entity. That is to say, even if the PDS is silent on the matter, it may be reasonable to regard an investment as an end investment.

18. Take a typical High Growth option which invests in infrastructure, for example. The PDS for this kind of option might generically foreshadow investments in airports, toll roads and ports. When making those investments (e.g. a particular airport), the superannuation fund would invest in a special purpose project vehicle or operating company which would either hold the assets or, as is more likely, invest in other vehicles which in turn hold the underlying infrastructure assets. The PDS would typically make no reference to the existence of these vehicles (let alone the particular airport), so it could hardly be said that it was clear to anybody that holdings in those vehicle were the end investment. However, these could nevertheless be reasonably regarded as an end investment since the vehicles (as a bundle) are a reasonable proxy for the underlying infrastructure assets, especially since the vehicles would not incur any significant costs in the nature of investment fees.

Comments on specific ASIC examples

19. As a technical matter, we note that some words may be missing from Example 5 – presumably the final sentence is intended to say ‘The company is not an interposed vehicle because it is listed and <u>*does not*</u> predominantly invest in securities or financial products’.

20. Example 6 gives an example of a situation where an infrastructure entity is not an interposed vehicle, and includes an assumption that the trustee of the superannuation fund or registered scheme does not emphasise the current or expected assets that are to be held in the infrastructure vehicle. ASIC should clarify that the focus is only on disclosure in the PDS, otherwise there is a risk that the eventual introduction of portfolio holdings disclosure (or existing voluntary website disclosures) could have the unintended consequence of causing what are, in truth, end investments to become interposed vehicles.

21. In addition, Example 8 could be made clearer by expressly noting that real property is not a security or financial product. Again, note our comments below that guidance should be provided as to how broadly this may be interpreted.

B1Q2 Are there additional examples that you consider should be included in RG97 which would assist in clarifying or explaining the interposed vehicle definition and its application?

22. It is essential for RG 97 to explain that a common-sense ‘look-through’ or ‘bundling’ approach can be taken when determining whether or not an entity carries on a business of investing in securities or financial products, and when determining whether an entity should be regarded as an end investment – essentially, so as to ignore any technical holdings in special purpose holding vehicles.

23. In saying this, we are only talking about special purpose vehicles that exist only for the purpose of holding the underlying investments; we are not talking about vehicles for the purposes of facilitating the management of a discretionary investment portfolio.

24. For example, many of the examples in draft RG 97 make the point that property trusts will often not be interposed vehicles, in part because real property is not a security or financial product, and therefore the first limb of the test in the class order is satisfied (i.e. they do not predominantly invest in securities or financial products).

25. However, this involves an over-simplification. Most real property investments are actually securitised or held through a holding vehicle. Even an entity which is colloquially regarded as investing in real property would technically hold interests in a range of vehicles which in turn hold the freehold or leasehold interests. However, this kind of technicality (which may only be appreciated by the lawyers acting for the entity) should not disqualify the entity from the exception and cause it to be deemed an interposed vehicle. It would be helpful if this could be clarified in RG 97. Perhaps this could be clarified by clearly stating that the mere fact that an entity may frequently acquire or dispose of securities does not mean that it is in the business of investing in securities, where that trading is merely incidental to some other line of business.

26. A similar issue arises when determining whether, based on the PDS, an investment should be regarded as an end investment. Take an infrastructure investment for example – say a superannuation fund invests in a particular airport. In colloquial terms, this would be regarded as an end investment. However, technically, the superannuation fund may have invested in a special purpose project vehicle which might in turn invest in another vehicle which in turn holds the leasehold interest and concession to operate the airport. RG 97 should clarify that the various holding vehicles can be ‘bundled together’ such that the whole arrangement is viewed as an end investment. Otherwise, costs incurred by the project vehicle (which would be airport operating costs, not investment costs) could technically be brought within the definition of indirect cost.

27. As noted earlier in this submission, special purpose project vehicles could be reasonably regarded as an end investment since the vehicles are a reasonable proxy for the underlying infrastructure assets, especially since the vehicles would not incur any significant costs in the nature of investment fees

28. It would be helpful if ASIC included examples to address this extremely common scenario.

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?

29. RG97.23 makes it clear that transaction costs are included in indirect costs for superannuation products and excluded for managed investment products (except for the costs of certain OTC derivatives, as explained in RG97.46 – RG97.52). Examples 9 – 12 are useful in this regard.

30. However, we query whether ASIC is compounding an anomaly which we have pointed out in numerous earlier submissions. While the Corporations Regulations do seem to suggest a different treatment of transaction costs depending on whether the PDS is for a superannuation product or a registered scheme, we suspect this may not have been intended. We have always queried whether this was an unintended consequence of

drafting changes which occurred as part of the Stronger Super reforms. It is difficult to identify any sensible reason why consumers should receive inconsistent cost disclosures solely because of technical differences in the type of legal structure of the product they have invested in.

31. It would be preferable for this inconsistency to be resolved (either way), whether through changes to the regulations or through ASIC class order, rather than compounding what appears to be an unintended anomaly.

32. It is worth pointing out a practical difficulty arising from the different approaches which have been adopted. If a superannuation product invests into a registered scheme, all other things being equal, the trustee of the superannuation product would rely on the PDS for the registered scheme (e.g. the information about the registered scheme's ICR) in order to calculate the superannuation product's own ICR. However, under the current provisions, a superannuation trustee cannot rely on registered scheme PDSs and must make further enquiries to ascertain the transaction costs which have been excluded from the registered scheme's ICR. In our experience, some responsible entities are likely to be reluctant to provide this information to a subset of their investors (i.e. superannuation funds) on the basis that this involves treating some investors differently from other investors by preferentially allowing access to cost information.

Requirement to reasonably estimate costs

B1Q4 Do you consider the guidance provided on the requirement to reasonably estimate indirect costs would assist you in complying with this requirement?

33. In our opinion, aspects of draft updated RG 97 could potentially confuse or mislead product issuers as to how ICRs should be calculated, especially those parts of RG 97 which refer to estimating indirect costs which may be incurred in future. This is because the ICR is inherently a retrospective figure. By definition, an ICR must always be calculated based on the last (i.e. completed) financial year: see Schedule 10, items 104(2) and 104(3).

34. Schedule 10 item 104(2) provides: '*'The ICR for a Product Disclosure Statement is to be determined for the financial year before the Product Disclosure Statement is issued'.* This is generally interpreted in the industry as requiring that the ICR figure disclosed in a PDS is calculated, in respect of all cost components included in the ICR, as the applicable amount actually incurred in the previous completed financial year. If ASIC disagrees with this interpretation, we think this should be expressly stated in RG97 and the rationale for ASIC's interpretation explained.

35. We do agree, however that, where there is some uncertainty about the indirect costs which were previously incurred in the last financial year, product issuers cannot omit those amounts altogether but should rather be including a reasonable estimate of those amounts to the extent that this is within their knowledge.

36. The first sentence in RG 97.35 is appropriate: '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.'

37. However the second sentence in RG 97.35 potentially goes too far: '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.' Schedule 10 of the Corporations Regulations is clear about how an ICR must be calculated for PDS purposes. That said, in our view, it would be reasonable for the 'Additional Explanation of Fees and Costs' section to include additional information about any components of the ICR which are likely to be higher or lower in future years.

38. We note the guidance provided for issuers of superannuation products at RG97.97, which refers to the obligations on superannuation trustees as fiduciaries and in complying with APRA's prudential standards and data reporting requirements as reasons why they will have sufficient information to be able to reasonably estimate indirect costs. We do not consider that this guidance is particularly helpful, because it does not point to the exact sources of information that may assist trustees.

39. For example, in our experience, it has been difficult for trustees to obtain information from investment managers in order to submit investment information to APRA, with the result that forms have made to be provided on a 'best endeavours' basis. We expect that similar difficulties will continue to be encountered unless there is a legal obligation on investment managers and trustees of underlying vehicles to provide the information in a timely manner.

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?

40. As a general proposition, we agree that issuers should document their procedures for making reasonable estimates (where indirect costs are not known) as a matter of sound governance and risk management. However, it should be borne in mind that some amounts may only need to be estimated on an ad hoc or infrequent basis. It should be recognised that in some cases a reasonable estimate may need to be formulated in real time and that there may not be an existing documented process for every amount that ever needs to be estimated.

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?

41. We refer to our 17 October 2014 submission to ASIC, *Proposed Class Order: Schedule 10 Technical Amendments*, wherein we queried whether the disparity in the treatment of buy/sell spreads and other transaction costs as between superannuation products and managed investment products was intended.

42. RG97.23 makes it clear that transaction costs are included in indirect costs for superannuation products and excluded for managed investment products (except for the costs of certain OTC derivatives, as explained in RG97.46 – RG97.52).

43. However, we query whether ASIC is compounding an anomaly which could be an unintended consequence of the Stronger Super reforms.

44. It would be preferable for this inconsistency to be resolved (either way), whether through changes to the regulations or through ASIC class order, rather than compounding what appears to be an unintended anomaly.

45. As also noted above, a practical difficulty which now arises is that superannuation trustees cannot rely on the PDSs for the registered schemes they invest in for the purposes of calculating their own ICRs. Instead, trustees must make further enquiries to ascertain the transaction costs which have been excluded from the registered schemes' ICRs. In our experience, some responsible entities are likely to be reluctant to provide this information to a subset of their investors (i.e. superannuation funds) on the basis that this involves treating some investors differently from other investors by preferentially allowing access to cost information.

46. In any event, it will likely be extremely difficult for superannuation trustees to ascertain the so-called buy-sell spread for over-the-counter derivatives. Unlike exchange traded derivatives which have a visible, ascertainable buy-sell spread, there will often be no ascertainable buy-sell spread for over the counter transactions. Trustees and their investment managers potentially make use of idiosyncratic or novel derivatives which are only priced if and when they enter into the trade with the relevant counterparty. It is entirely likely that, in many cases, there will be no price data for the reverse trade. It is unrealistic to expect that a commercial party would approach another commercial party, asking them to quote on both sides of a particular trade – which is essentially what a superannuation trustee would have to do in order to calculate their ICR under the new framework.

47. Superannuation trustees typically appoint external investment managers to manage the bulk of their assets, many of whom enter into over-the-counter derivatives on their behalf without reference to the trustee. The class order and RG 97 will effectively require trustees to go back to their investment managers and renegotiate the terms of their investment management agreement so as to require managers to ascertain the buy-sell spread for every over-the-counter derivative trade.

48. On balance, this is likely to be an area where trustees end up making reasonable estimates when calculating their ICRs.

49. If this approach is to be adopted, it would be helpful to include guidance as to how the buy-sell spread may be apportioned where the relevant derivatives exposure straddles a financial year. For example, a trustee may enter into a derivatives position with a 2-year tenor – can the buy-sell spread be apportioned across two financial years?

50. Equally, a trustee might enter into a 3 month hedge contract in June, a few weeks before the end of the financial year. This would again lead to uncertainty over how the (estimated) buy-sell spread should be apportioned.

51. Finally, whereas the class order makes express reference to buy-sell spreads on over-the-counter derivatives, it is silent as to the correct treatment of buy-sell spreads on exchange-traded derivatives. It would be helpful if ASIC could confirm in RG 97 that there was no intention for buy-sell spreads on exchange-traded derivatives to be caught by the general definition of indirect costs. Buy-sell spreads on exchange traded derivatives (or for that matter, on over the counter derivatives) are not costs which are charged in any sense of the word. These are classical buy-sell spreads, which (in simple terms) are merely the mathematical difference between the highest price that a prospective buyer is willing to pay, and the lowest price that a prospective seller is willing to accept. Ultimately, that gap must be bridged in order for a transaction to occur, and this culminates in the agreed transaction price. The transaction price is then used as the basis for calculating investment performance,

capital gains tax and so forth. There could be unintended consequences if ASIC were to suggest that part of the transaction price should be reclassified as some other type of cost.

52. This confusion perhaps arises because the definition of transaction costs has historically included buy-sell spreads; but the reference to buy-sell spreads in that context was most likely a reference to the buy spreads and sell spreads that are charged when investing into or withdrawing from a product. That kind of buy spread and sell spread is a charge, which is charged to investors and collected by the product issuer. It is different from the classical buy-sell spread referred to above.

53. Given the focus on the so-called buy-sell spreads on over the counter derivatives, a clear statement by ASIC as to how buy-sell spreads on exchange traded derivatives would be helpful. In this regard, for the reasons set out above, it would appear to us that they would not be included in the definition of indirect costs (i.e. because they are not costs).

Inclusion of additional voluntary information

B1Q8 Do you consider this guidance to be appropriate?

54. We agree that it should be permissible for issuers to include notes to explain instances where strict compliance with the prescribed template or prescribed annual example could be misleading.

55. As to whether additional information should be included as a matter of good practice to explain what component of fees and costs are paid to related parties and why, we are not sure that this would necessarily assist in managing conflicts of interest. We are also concerned that, particularly in a superannuation context, there may be an implicit suggestion that disclosure would give permission to a trustee to pay fees and costs to related parties where the law might otherwise prohibit it or might only allow it on certain terms (for example where the fees or costs are paid on an arm's length basis). We note that disclosure alone is unlikely to be sufficient to satisfy the requirement in section 52(2)(d) of the SIS Act to *ensure* that any conflict does not adversely impact the beneficiaries' interests.

Performance fees

B1Q9 Do you consider this guidance to be appropriate?

56. We disagree with several aspects of the guidance.

57. We think it would be useful for RG 97 to identify the different situations in which performance fees could become payable and consider how those different situations would give rise to different approaches to disclosure.

58. There are different kinds of performance fees which could potentially be charged to members of superannuation funds and registered schemes. For example:

- Some performance fees may be charged by the product issuer for the overall performance of the product;

- Some performance fees may be charged by an investment manager based on the performance of a particular portfolio that they have been appointed to manage; and
- Some performance fees may be charged by an interposed vehicle through which the superannuation fund or registered scheme has invested.

Performance fees levied by product issuer

59. The first kind of performance fee could potentially be disclosed as either an investment fee or through the ICR, depending on the mechanism through which the particular product issuer levies the fee.

60. If the performance fee is disclosed as an investment fee, we agree with the commentary in RG 97 as to how the performance fee that will apply into the future should be disclosed.

61. However, RG 97 does not adequately outline the approach that should be taken in cases where the performance fee is charged indirectly and therefore included in the ICR. As noted earlier in this submission, an ICR is inherently a backward-looking number. In this scenario, the published ICR should only ever be calculated based on performance fees which were actually incurred in the most recently completed financial year. If for some reason the precise amount of performance fees in the previous financial year were to be unknown, it would be reasonable to expect that product issuers would include a reasonable estimate.

62. RG 97.55 refers to 'incorrect practices' which include 'using the previous year's performance fees to indicate the expected fees for the current year'. This statement goes too far, especially since issuers are required to use the previous year's performance fee when calculating their ICR. Further, cl 209(b)(iii) of Schedule 10 of the Corporations Regulations specifically requires the amount of the performance fees (in the previous year) to be published in the PDS. Issuers who publish the previous year's performance fee are doing exactly what the regulations require them to do. If ASIC has concerns that a lump sum dollar figure would not be meaningful to investors, it would be legitimate to suggest (i.e. within the parameters of the regulations) that the dollar amount of performance fees should be converted into a simple percentage by dividing the total performance fees in dollars by the total net assets of the relevant product. This would allow investors to understand the proportion of the ICR attributable to performance fees in the prior year.

Performance fees charged by external investment managers and interposed vehicles

63. Where performance fees are charged by external investment managers and interposed vehicles, performance fees would almost certainly be included in the ICR and would not be disclosed as an investment fee. As such, for the reasons outlined above, the current law does not require forward-looking estimates of performance fees.

64. In these cases, cl 209(b) of Schedule 10 of the Corporations Regulations would still require explanatory information about the performance fees.

65. In our view, it should be borne in mind that there would likely be a multiplicity of performance fee arrangements that have been entered into with any number of different investment managers and interposed vehicles. Each performance fee arrangement would be different. The rates of performance fees would differ in each

case and may be activated by outperforming different benchmarks by different hurdle amounts.

66. It is, in our view, impractical and extraordinarily difficult to estimate the combined performance fee which might be payable on a whole-of-product basis in a future period in a meaningful way. This depends on:

- Which investment managers outperform and by how much;
- The size of the portfolios managed by those investment managers; and
- Whether any previous underperformance can be 'clawed back' from future performance fees; and
- Whether there is a cap on the amount of performance fees which can be taken by the relevant investment managers.

67. Even if an assumption were to be made about future investment performance on a whole-of-product (or macro) basis, the amount of performance fees depends on micro factors such as those listed above.

68. We are also concerned that the comments in RG 97.109 suggesting that, where there is a range of performance fees, the highest fees in the range must be used involve an oversimplification. In each asset class, there may be a number of investment managers which each charge a range of performance fees. If the highest performance fee (out of all the investment managers) is paid to, say, a private equity manager, it would be misleading to focus on this figure because only a relatively small proportion of the product might be invested in the private equity asset class (let alone that particular private equity manager). A product might invest a much larger proportion of its assets in Australian equities which may have far more favourable performance fee arrangements. While a weighted average may appear to be a solution to this particular issue, even this would involve making an assumption as to what the future performance of each asset class will be.

69. Further, determining the 'highest fees in the range' is not necessarily an obvious task. Often the rate of performance fees is set higher in cases where the manager must achieve a higher hurdle (in recognition of the fact that it is more difficult for the manager to earn the performance fee). To illustrate the point, consider which of the following fees is the highest fee:

- 10% of all performance once the manager outperforms the benchmark by more than 2%;
- 5% of all performance once the manager beats the benchmark.

70. The second of these arrangements is potentially the more 'expensive' arrangement, given the lack of a hurdle, despite having a lower headline capture rate.

71. In our view, RG 97 should recognise the complexity around performance fees, especially when they are being levied by numerous external parties, and acknowledge that there may not be a concise figure which could be disclosed to investors without misleading them.

72. We agree that a lump-sum figure (in dollars) based on the total of all performance fees paid in the previous year is unlikely to be meaningful to investors. However, converting this into a percentage (i.e. expressing the previous year's performance fees as a percentage of total funds under management) would fairly convey the extent to which the ICR could include performance fees. While this may be seen as backward looking, it needs to be borne in mind that the ICR is inherently a backward looking

figure. In the same way that the ICR could be higher or lower in future years, so may the performance fees or indeed any other indirect cost which is included in the ICR.

B1Q10 Are there scenarios that you consider it would be appropriate to give further guidance on?

73. Disclosure of performance fees[1] has always been problematic because the extent to which past performance (and therefore past performance fees) will be repeated in the future is uncertain. ASIC has acknowledged this point at RG97.55 – RG97.56[2] and again at RG97.109. From a practical perspective, it would be useful to include examples of when ASIC *would* consider estimates of performance fees to be based on reasonable grounds.

Insurance Disclosure

B1Q11 Do you consider this guidance to be appropriate?

74. At RG97.113, ASIC has stated that disclosure of insurance costs should include the components of insurance premiums (including adviser commission) and how each component affects the member, the imposition of any loadings (including additional amounts charged because the member chooses to pay monthly rather than annually), any additional policy or administration fee and how stamp duty is handled for income protection premiums.

75. We consider that the disclosure of adviser commission as a component part of an insurance premium is consistent with item 209(e) of Schedule 10 and is not controversial.

76. Similarly, we also consider that the inclusion of additional policy or administration fees is consistent with item 209(i) of Schedule 10.

77. It may be difficult for occupational loadings to be disclosed in a PDS, however, because they may be imposed by an insurer as part of the underwriting process and therefore not known at the time a PDS is prepared. Those types of loadings are different, in our view, to additional amounts charged for monthly, rather than annual, premiums. A higher premium cost in those instances should be disclosed, because it is in effect a flexible charging structure, consistent with item 209(l) of Schedule 10.

B1Q12 Do you recommend any other guidance that should be included to further assist industry in this area?

78. There is a possible issue with the way the relief in Class Order 14/1252 interacts with the periodic statement disclosure requirements.

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[1] For managed investment products, estimated performance fees are included in management costs. For superannuation products, performance fees are included in investment fees. Then for both superannuation and managed investment products, the Additional Explanation of Fees and Costs section of the PDS must include a statement of how performance fees affect administration and investment fees (or management costs for a managed investment product), the method of calculating them and the amount of the fees, or an estimate if the amount is not known.

[2] There appears to be a typographical error towards the end of RG97.55 – it seems that 'excepted' should be 'expected'.

79. The definition of indirect costs inserted by new item 101A makes it clear that an indirect cost does **not** include an amount that is a fee under section 29V of the SIS Act. So if an administration fee or an investment fee is charged by way of a percentage deduction from returns (rather than deduction from the member's account) it would not be included as part of the Indirect Costs Ratio (to prevent double counting).

80. The problem is that on a periodic statement, if percentage based fees are not included under item 301(1) of Schedule 10 as indirect costs, there might be no disclosure of these amounts. (Currently, because the amounts are deducted from returns, they are reported under Part 3 of Schedule 10 as part of the ICR.)

81. Fees that are deducted directly from member's accounts are, of course, reported in a periodic statement in dollars as a transaction cost in accordance with regulation 7.9.75(1)(a), but the industry practice is **not** to list percentage based fees as transaction costs (or to convert them to dollars) because they are counted as part of the ICR). Going forward, if ASIC takes the view that these percentage-based fees will need to be disclosed in dollars as transaction costs (perhaps under regulation 7.9.75(1)(b)), then it would be useful for guidance to be given to the industry earlier rather than later – because trustees will need to change their periodic statement templates (which are system-based).

Attachment A: Profile of the Law Council of Australia

The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its Constituent Bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Large Law Firm Group, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- The Large Law Firm Group (LLFG)
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of approximately 60,000 lawyers across Australia.
The Law Council is governed by a board of 23 Directors – one from each of the constituent bodies and six elected Executive members. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive members, led by the President who normally serves a 12 month term. The Council's six Executive members are nominated and elected by the board of Directors.

Members of the 2015 Executive are:

- Mr Duncan McConnel, President Mr Duncan McConnel, President
- Mr Stuart Clark, President-elect
- Ms Fiona McLeod SC, Treasurer
- Dr Christopher Kendall, Executive Member
- Mr Morry Bailes, Executive Member
- Mr Ian Brown, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.