



Law Council  
OF AUSTRALIA

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# Disclosing fees and costs in PDSs and periodic statements

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**Australian Securities and Investment Commission**

**Submission by the Superannuation Committee of the Legal Practice Section of the Law  
Council of Australia**

**21 August 2015**

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## Executive Summary

We thank ASIC for the consultative approach which has been adopted in connection with these reforms.

We acknowledge that ASIC has circulated several drafts, each of which have included significant changes which have endeavoured, with varying degrees of success, to address some of the concerns which have been identified by industry.

### **Undue complexity**

We remain troubled by the complexity of several aspects of the revised class order provisions. In our opinion, many industry participants and legal practitioners would struggle to understand some of the proposed new provisions. Consideration should be given to redrafting those provisions so that they are clear, concise and effective. Given the membership of our committee, we could assist with the drafting if that would assist ASIC.

We have previously proposed alternative drafting solutions for the definitions of 'indirect cost ratio' (**ICR**) and interposed vehicle and these are extracted below in this submission. We request that ASIC give them further consideration.

At the very least, the proposed changes should be implemented by re-issuing class order 14/1252 instead of introducing a new class order which modifies an earlier class order. This would be consistent with other ASIC initiatives which are targeting reductions in red-tape.

### **Problematic approach to the ICR / investment fee 'overlap' issue**

Currently, the definitions of 'investment fee' and 'ICR' overlap and ASIC is proposing to remedy this by shifting the overlapping portion out of 'ICR' and into the 'investment fee' category. We have previously made numerous submissions which identify the many problems arising from ASIC's proposal to shift certain costs out of the 'indirect cost' category and into the 'investment fee' category. These concerns have still not been addressed. It is concerning that this change is being pursued notwithstanding the problems which it creates, even though there appears to be no particular benefit from making the change. The most recent draft goes so far as to create a new category of 'indirect fee' in order to close a disclosure gap which would otherwise be created by the reforms.

It would be better to cure the overlap-issue by maintaining the well-accepted status quo as to how certain costs are categorised for disclosure purposes – i.e. the overlap-issue should be cured by carving indirect costs out of the 'investment fee' category.

ASIC's current facilitative approach – which essentially allows issuers to determine which category an amount should be allocated to – is preferable because it avoids double-counting while at the same time ensuring that retail clients receive adequate (and, in our view, better) disclosure.

## **Problematic definition of ‘interposed vehicle’ and differential treatment of superannuation funds and managed funds**

Even as an objective observer, we are concerned that ASIC is widening the regulatory gap between superannuation funds and managed funds despite there being no articulated reason for imposing more stringent requirements on superannuation funds. This will make it even harder for superannuation funds to comply with the new requirements. Superannuation funds will be required to make more comprehensive disclosure of costs incurred within managed funds which are ‘interposed vehicles’. However, superannuation funds will not be able to rely on the disclosure documents they receive from managed funds because those disclosure documents will have been prepared in accordance with less-stringent disclosure rules which differ from those applying to superannuation funds. We urge ASIC to design these reforms with compliance in mind, rather than introducing changes which, by design, make compliance more challenging than would otherwise be the case.

Ultimately, there is a genuine prospect that these provisions will fail to achieve their apparent aim. The current drafting effectively allows various opinions to be formed as to what the intention of a particular investment was, and the cost disclosure obligations would depend on what opinion is reached. There is a real risk that, in practice, those segments of industry which currently fail to disclose indirect costs will merely form the relevant opinions for the purposes of continuing not to disclose the indirect costs of their investments. Further, most funds would struggle to form the relevant opinions through lack of data and the sheer quantity of investments and, in practical terms, would have to make educated guesses as to whether particular investments are caught by the definition of ‘interposed vehicle’. In our view, it is not reasonable to place trustees in such a position and we query how ASIC would approach enforcement in any event as it would encounter the same practical difficulties.

## About the Law Council of Australia's Superannuation Committee

1. This submission has been prepared by the Law Council of Australia's Superannuation Committee (the Committee), which is a committee of the Legal Practice Section of the Law Council of Australia.
2. The Law Council of Australia is the peak national representative body of the Australian legal profession; it represents some 60,000 legal practitioners nationwide. [Attachment A](#) outlines further details in this regard.
3. 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.

## General comment on drafting complexity

4. The proposed provisions regarding interposed vehicles and costs associated with derivatives are quite difficult to comprehend. Ultimately, higher rates of compliance are likely to be achieved if industry participants can readily understand what is expected of them and we urge ASIC to revisit the drafting with a view to streamlining these aspects of the proposed class order.
5. We draw ASIC's attention to the following comments by Buchanan J of the Federal Court in *Casaclang v Wealthsure Pty Limited* [\[2015\] FCA 761 at \[236\]](#):

*The standards of conduct which are set out in the Corporations Act in general and in Chapter 7 in particular should operate as a reliable guide to conduct, readily ascertainable and capable of equally ready understanding. They should be accessible and comprehensible by those whose conduct is governed and by those whose interests might be affected – i.e. consumers and clients, small as well as big. The provisions with which I am dealing in this judgment fall short of that objective by a large margin, even for trained lawyers. That is unfortunate. The result is that the provisions of Chapter 7 do not, in my view, act as an effective guide to conduct at all. They represent a complicated catalogue from which to select instruments of retribution well after loss or damage has been suffered. The applicants in the present case have persevered, but justice for them and others (and for licensees) should not depend upon such complexities as Chapter 7 presents, and should not be endangered by the real possibility of misunderstanding or misapplication of its provisions.*

6. In our view, aspects of the proposed class order fall short of the standard articulated by Buchanan J in the above passage.
7. We appreciate that this is an area of some complexity. Given the legal experience of our committee's membership, we would be pleased to work with ASIC and assist in drafting a reformulated class order which is clear, concise and effective.
8. As an aside, draft RG 97 includes many typographical and syntactical errors which we assume would be addressed in the final rounds of editing and peer review.

## Changes to definitions of ICR and investment fees

9. The definitions of 'investment fee' and 'ICR' do overlap and there is merit in removing the overlap to avoid double-counting of fees for disclosure purposes. This should be achieved by restoring the status quo that existed before the Stronger Super reforms (i.e. indirect costs should be included in the ICR and not in 'investment fees'). ASIC is proposing to take the opposite approach – i.e. shifting some indirect costs out of ICR and into 'investment fees'.
10. Note that the overlap-issue has been tolerable because of ASIC's accommodative approach which has, in essence, allowed funds to choose whether to include indirect costs in ICR or in investment fees. A continuation of this approach would be preferable to what is now being proposed.

### Summary of concerns

11. The following table summarises the differences between the status quo and the proposed reforms and why we consider the proposed reforms to be a step backwards.

Status quo	Proposed reforms
Investment fees are stated with precision, but ICR is estimated	Neither investment fees nor ICR are stated precisely; both are estimates
Investment fees are fees in the ordinary sense	Investment fees will include fees as well as amounts which are not fees in the ordinary sense (i.e. indirect charges)
28 days' notice must be given before increasing investment fees	Not practical to comply with the 28 day notice requirement when an estimate is exceeded during the course of a year
Indirect cost ratio is representative of all indirect costs	Indirect cost ratio is misleading because it only includes some indirect costs
Performance fees paid to external investment managers are all included in the ICR	Performance fees paid to external managers are spread between 'investment fees' and ICR depending on whether an interposed vehicle is involved
Periodic statements list directly charged fees with a catch-all disclosure of indirect costs which is consistent with the Product Disclosure Statement (PDS) disclosure	Periodic statements list directly charged fees, as well as 'indirect costs' and a newly created category of 'indirect fees' which is inconsistent with PDS disclosure

## Detailed outline of concerns

12. We refer to our numerous written submissions and discussions regarding the proposed definitional changes. We have identified our numerous concerns previously and have not restated them in detail in this submission. Those concerns still exist.
13. The ICR concept will become largely redundant and, in effect, will become a figure which only represents costs incurred through interposed vehicles. The term 'indirect cost ratio' will become a misleading one, because it will cease to include all indirect costs.
14. These changes will create new ambiguity whereas before there was none.
15. Previously 'investment fees' were all investment costs which were directly charged to members (i.e. they were fees in the ordinary sense) and ICR included all indirect amounts. Under the proposed changes, indirect costs will now be spread between investment fees and ICR. The common-sense distinction between investment fees and ICR would be removed.
16. It will be more difficult for members to understand whether amounts designated as 'investment fees' are charged directly or not.
17. Previously, investment fees could be disclosed with precision and were forward looking. Under the proposed changes, 'investment fees' will include estimates which, in practical terms, are unlikely to correspond to the exact amount actually borne by funds and members. In other words, both 'investment fees' and 'ICR' will become estimates.
18. This is a step backwards from the status quo where, although the ICR is effectively an estimate, at least the investment fees could be disclosed with certainty.
19. The proposed changes will reduce the consumer protection provided by the requirement to give 28 days' notice before making a change to fees.
20. If 'investment fees' are disclosed on an estimated basis, it becomes ambiguous when the requirement to give 28 days' notice is triggered (if at all). If an estimate only ceases to be accurate when it is exceeded, actual fees only exceed the disclosed fees once the estimate has been exceeded – by which time it will be impossible to give 28 days' advance notice of the increase. Trustees would typically not be in a position to control third party costs and so an estimate could be exceeded through no fault of the trustee.
21. From a rule of law perspective, it is concerning that changes are being made which render other statutory requirements impossible to comply with.
22. The proposed changes are creating new issues which do not presently exist and will expose funds to an implementation burden which seems disproportionate to whatever policy end these changes are trying to achieve.
23. This is highlighted in the periodic statement context. Previously, the transaction listing section would disclose all fees deducted from a member's account, and there would separately be dollar-disclosure of the indirect costs which had been borne in respect of a member's account. This part of the status quo worked effectively. However, the proposed changes create a problem which did not previously exist. Once 'investment fees' start including amounts which are not actually fees, it creates a disclosure gap. Indirect investment costs do not appear in the transaction listing (because they are not

fees) and they do not appear in the separate disclosure of 'indirect costs' because they have been carved out of that category. This means there would be a category of costs which are not required to be disclosed.

24. This gap is created by ASIC's proposed changes. To address the gap, ASIC is now proposing to create a new category of fee, called an 'indirect fee'. This is a category which only applies to periodic statements and therefore leads to inconsistency in terminology between PDSs and periodic statements.

- In PDSs, members would have to understand the difference between investment fees (which includes actual fees as well as amounts which are not really fees) and indirect costs (which are some, but not all, of the indirect costs they bear).
- In periodic statements, members must grapple with indirect costs as well as indirect fees, on top of the listing of ordinary fees.

25. An indirect fee is nothing more than an indirect cost. It seems a pointless distinction which serves no purpose other than to address some of the problems created by other aspects of ASIC's reforms.

26. We urge ASIC to abandon this aspect of the proposed change and to allow funds to continue disclosing indirect investment costs through the ICR.

27. It is perhaps worth distinguishing two typical scenarios. Some trustees recover third party expenses from the assets of the relevant investment option by way of reimbursement of expenses. No fee is levied. In these cases, the argument why ICR is the appropriate category for disclosing the historical level of those costs is strongest. In other cases, the trustee sets a flat fee in advance which is intended to be sufficient to cover third party costs, often with a margin which would mean it has some characteristics of a fee. These arrangements also operate as a cap – if third party costs exceed the flat fee, the trustee must bear those costs. Conversely, if third party costs fall below the flat fee, the difference may be retained by the trustee. While these arrangements have fee-like characteristics, they are deducted indirectly meaning they also have ICR-like characteristics. However, this does not detract from the fact that ordinary expense recovery arrangements (i.e. the first scenario outlined above) are not fees and are better characterised as ICR.

28. We reiterate the solution which we previously suggested in our email of 5 May 2015, extracted below.

- 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 **the following but only to the extent that they are charged to members as a fee:***

*(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.*

## Treatment of derivative costs

29. The drafting regarding derivative costs is particularly complex and should be considerably simplified.

30. We understand the intention behind the provisions which would require the difference between underlying returns and actual returns to be included in the calculation of indirect costs. However, we anticipate that trustees may find it difficult to ascertain this information from the interposed vehicles in which they invest.

31. The provisions which would require indirect costs to include the difference between acquisition price and disposal value (as at the date of acquisition) are problematic. The concerns identified in our earlier submissions regarding the proposed inclusion of buy-sell spreads on derivatives therefore continue to exist. This component would in many cases be impossible and/or impractical to ascertain, regardless of whether the relevant derivative had been acquired by the trustee directly or through an interposed vehicle.

## Differential treatment of managed funds

32. We reiterate our previously expressed concerns that superannuation funds and managed funds are being treated differently.

33. When the Stronger Super reforms were implemented, it was presumably an accident that transaction costs ceased being excluded from the definition of indirect costs for superannuation funds (but continued being excluded from the definition of management costs for managed funds).
34. This anomaly should be rectified by ASIC rather than compounded. Investors in both categories of product should receive comparable disclosure. We urge ASIC to consider levelling the playing field by clarifying that transaction costs can be excluded from disclosure for both categories of entity, or that they must be included for both.
35. Even if transaction costs are to be excluded for managed funds, it does not follow that all costs associated with derivatives used for hedging purposes should be regarded as 'transaction costs'. A cost is a 'transaction cost' if it was the cost of entering into a transaction, regardless of what the purpose of the transaction was. Hedging transactions may have costs embedded which are properly regarded as 'transaction costs' as well as other costs.
36. In practice, it would be easy for responsible entities to characterise a derivatives trade as being for hedging purposes in order to justify excluding the associated costs.
37. Apart from our philosophical concerns that superannuation funds are being put at a systematic competitive disadvantage, we also have a concern regarding the impact on compliance rates. If managed funds were subject to the same disclosure regime, trustees of superannuation funds could rely on the PDSs given to them by the managed funds through which they invest. However, the proposed class order would leave superannuation funds unable to rely on the PDSs they receive from those managed funds and instead they would need to seek further information from those funds which may or may not be forthcoming.

## Definition of interposed vehicle

38. As indicated in our earlier submissions, we struggle with the proposed definition. The proposed definition remains complex and is counter-intuitive since it focusses on elements which are divorced from what the concern ought to be.
39. We imagine that the driver here is to ensure that amounts in the nature of investment management costs are brought to account when preparing PDS fee disclosures. However, the drafting does not at any stage refer to the nature of the costs which are being incurred downstream. Instead, the drafting focusses on whether or not entities hold securities in excess of some arbitrarily selected limit of 70% of total assets.
40. It seems to us that even if a vehicle does hold securities in excess of that limit, there could easily be costs incurred within that vehicle that are not of a kind that should be included in the ICR calculation.
41. Similarly, vehicles with holdings below this 70% vehicle could just as likely incur costs which ought to be included in ICR calculations.
42. The proposed drafting suggests that holdings which confer control over an entity should be disregarded. However, it is unclear whether those holdings are being disregarded for the purposes of the numerator or denominator in the equation. This should be clarified and presumably they are only meant to be disregarded for the purposes of the numerator. If disregarded from both the numerator and the denominator, every entity would have 100% of its residual holdings in entities which do not confer control.

43. In addition to the 70% threshold, there are further grounds on which particular entities could be deemed to be (or not be) interposed entities. These grounds focus on what could reasonably be inferred from PDS disclosure.
- A listed entity will be an interposed entity if – based on the PDS – it could not be reasonably regarded as an end-investment.
  - An unlisted entity will be an interposed entity if – based on the PDS – it could be reasonably regarded as conduit investment.
44. From a drafting point of view, we point out that there are different burdens of proof depending on whether or not an entity is listed and this gives rise to a bias. There may be cases (in fact, in practice there will probably be many cases) where there are reasonable grounds to reach either conclusion.
- If the asset is listed, the fact that there are reasonable grounds to conclude that it is an end investment will mean that it is shielded from being treated as interposed vehicle.
  - However, if the same entity were to be unlisted, the fact that it could conceivably be regarded as a conduit-investment would mean that it would be deemed to be an interposed entity.
45. In any event, it is quite likely that PDSs would in many cases be silent on the point meaning that it is not possible to reach any particular conclusion having regard to the contents of the PDS.
46. We note that large superannuation funds have many thousands of investments. It is unrealistic to expect that superannuation funds will have an accurate knowledge of the balance sheet of every one of those investments. The proposed class order would require trustees to know (with precision) whether or not the total holdings held by every entity in which it has invested are more or less than 70% of the relevant entity's balance sheet, and in turn to know which downstream shareholdings confer control on another entity so that those holdings can be disregarded. Technically, this would require knowledge of matters other than percentage-based levels of ownership, but influence over financial and operating policies and board composition, as well as shadow directorships. In reality, given the proposed drafting, funds may have no practical alternative other than to make educated guesses at a macro level as to which investments are caught by the definition of 'interposed vehicle'. We do not consider it reasonable for the class order to place funds in such a position. We similarly query how ASIC would approach enforcement.
47. We therefore reiterate the drafting solution which we suggested in our email of 5 May 2015, extracted below:

*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)...; 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).*

## 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 its constituent bodies consisting of 16 Australian State and Territory law societies and bar associations and the Law Firms Australia. 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
- Law Firms Australia
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of more than 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 as at 1 July 2015 are:

- Mr Duncan McConnel, President
- Mr Stuart Clark, President-Elect
- Ms Fiona McLeod SC, Treasurer
- Mr Morry Bailes, Executive Member

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

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