



17 October 2014

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Dear Sir

**Proposed Class Order: Schedule 10 Technical Amendments**

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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- Mr Luke Barrett, Chair, Legislation and Policy Subcommittee T: 03 9910 6145  
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Yours sincerely

A handwritten signature in black ink, appearing to read "M Hagan".

MARTYN HAGAN  
SECRETARY-GENERAL



Law Council  
OF AUSTRALIA

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# Proposed Class Order: Schedule 10 technical amendments

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## **Australian Securities & Investments Commission**

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

**17 October 2014**

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## Executive Summary

1. The Law Council of Australia is pleased to have the opportunity to respond to this consultation.
2. This submission has been prepared by the Law Council's Superannuation Committee (the Committee), which is a committee of the Legal Practice Section of the Law Council of Australia.
3. The Committee agrees that technical modifications are required to be made to Schedule 10 of the Corporations Regulations and is generally supportive of this being implemented by way of Class Order. Of course, it would be preferable for Schedule 10 itself to be amended.
4. That said, several issues arise from the proposed drafting of the Class Order which, in the Law Council's view, warrant further consideration.
5. With regard to the proposed new definition of "interposed vehicle":
  - The drafting is confusing and difficult to interpret, for example, due to several double-negatives in the drafting.
  - In creating carve-outs from the definition of "interposed vehicle", the Committee understands that ASIC had particular scenarios in mind. However, those scenarios have been described indirectly by reference to circumstances which might typically exist in those scenarios, instead of by clearly articulating the essence or underlying principle that was originally in mind. For example, the drafting focusses on how issuances and redemptions by a listed vehicle are priced, and on particular inferences that may have been drawn by readers of the PDS. In contrast, the Committee understands that the carve outs were intended to focus on whether or not a particular investment was intended to be an investment 'in its own right' or whether it was intended to be a conduit or means of gaining exposure to the assets held by the vehicle. If so, it would perhaps be clearer and simpler if this principle were incorporated into the proposed new definition.
6. With regard to the proposed new definition of "indirect cost":
  - The proposed new definition does not completely address the double-counting issue when disclosing fees and charges.
  - We query why superannuation funds must calculate their ICRs according to a broader methodology than what applies to managed investment products, which results in superannuation products appearing to have higher ICRs and therefore being placed at a competitive disadvantage relative to managed investment products.
  - Disproportionate attention is given to buy-sell spreads on derivatives and the Committee queries why the treatment should vary depending on whether the derivative is traded over the counter or exchange traded, or whether it is held by a superannuation product or managed investment product.
  - The draft class order is inconsistent with Schedule 10 insofar as it purports to include buy-sell spreads in the ICRs for managed investment products and this aspect of the draft class order could be ineffective.
  - The definition of indirect cost should be expressed in the past tense because ICRs are backward looking figures for the most recently completed financial year. This will avoid confusion that product issuers are required to formulate forward looking estimates of charges under the class order.
7. The Superannuation Committee has also identified several technical modifications which the class order ought to make to the PDS and periodic statement requirements for pension products.

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

8. This submission was drafted for the Law Council of Australia by the Superannuation Committee (the Committee), which is a committee of the Legal Practice Section of the Law Council of Australia. The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. The Committee prepares submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.
9. 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.

## Definition of interposed vehicle

### Double-negatives

10. The definition of interposed vehicle may be difficult for some readers to interpret. The revisions which were marked-up in the Revised Draft Class Order certainly assist with reducing some of the ambiguity. However, it is still likely to be a difficult definition for some to interpret.
11. Much of the uncertainty stems from the numerous double-negatives in the drafting.
12. For example, for anything to be an interposed vehicle, it must be entity which is not one to which various descriptions apply. Some of those descriptions also include "nots". Take paragraph (a) for example. Here, an interposed vehicle is a body which is not one which does not regularly issue and redeem securities at a particular issue price (amongst other things). The double-not is confusing. Is the drafting trying to say that an interposed vehicle is one which does regularly issue and redeem units (amongst other things)?
13. We gather ASIC's intention is for any kind of entity to be an "interposed vehicle" subject to the limited exceptions described in paragraphs (a) to (d). If so, simpler drafting might be adopted for the introductory words – for example:  
"interposed vehicle" means any body, trust or partnership in which a superannuation product or managed investment product has invested unless:
  - (a) ...
  - (b) ...
  - (c) ...; or
  - (d) ..."

### Exception for some listed bodies depending on issue and redemption prices

14. Paragraphs (a) and (b) create flexibility to leave expenses out of the ICR where a product invests in a listed entity which "does not regularly issue and redeem securities or interests in the body at a price based on its net assets".
15. The Committee understands that, in drafting these paragraphs, ASIC has the following considerations in mind:
  - (1) Some listed investment vehicles are passively managed and others are actively managed.
  - (2) A superannuation product or managed investment product which invests in a passively managed vehicle is more likely to be using the investment as a conduit to obtain exposure to the underlying securities and, because of this, the costs

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incurred by the vehicle should be included in the ICR as they are costs associated with acquiring the (underlying) desired exposures.

- (3) A superannuation product or managed investment product which invests in an actively managed vehicle is more likely to see the investment in the vehicle as an investment in its own right and, because of this, the costs incurred by the vehicle should not be included in the ICR because they should not be seen as costs incurred in acquiring the desired exposures.
  - (4) Passively managed funds generally issue and redeem units at net asset value.
  - (5) Actively managed funds generally do not issue and redeem units at net asset value.
  - (6) Therefore the exceptions in paragraphs (a) and (b) of the new definition do not refer to whether or not a fund is passively managed or actively managed, but instead focus on whether or not interests are regularly issued and redeemed at net asset value.
16. Fee disclosure is an important matter and exemptions from the obligation to include amounts in the ICR should be carefully drafted in a targeted fashion, otherwise there will be a risk of the exceptions being applied more broadly than intended. This could result in systemic under-disclosure – or at best, inconsistent disclosure – of the true ICRs applicable to products. With that sentiment in mind:
- We query whether there is an adequate basis for the premises set out in paragraphs (2) and (3) above, and whether focussing on the type of investment strategy is too tenuous a basis for characterising the intention of an investment;
  - We query whether the premises in paragraphs (4) and (5) above will necessarily always be true and whether the exception might have broader application than intended in cases where the assumption about how passive and active funds calculate unit prices does not hold true; and
  - We therefore query whether it would be better for paragraphs (a) and (b) in the new definition to directly refer to the specific situations that they are directed towards. For example, they seem to be directed at listed vehicles which have been invested in predominantly as an investment in their own right, rather than for the purpose of gaining exposure to the underlying securities. If this is indeed the intention, the drafting should say so.
17. In any event, the phrase “does not regularly issue and redeem securities or interests at a price based on its net assets” is ambiguous in several regards.
- The drafting is obviously focussing on regularity – but regularity of what? Is the question whether interests are redeemed and issued regularly? Or whether issuances and redemptions take place at a price based on net assets? What if interests are issued and redeemed rarely (i.e. not regularly), but when they are, they are always issued and redeemed at net asset value?
  - The use of the word “and” is relevant too. To qualify for the exemption, the body must not regularly issue and redeem interests at net asset value. What if the issue price is calculated on a different basis from how the redemption price is calculated? It is conceivable that the issue price might be based on net asset value whereas the redemption price is not (or vice versa). In this case, the body would qualify for the exemption and costs could be left out of the ICR calculation – is this intended by ASIC?

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## Exception based on PDS disclosure

18. Paragraph (c) of the new definition creates an exception based on what is disclosed and how investors might reasonably interpret the PDS disclosure.
19. The Committee understands that paragraph (c) is intending to differentiate between:
  - situations where a PDS states that a product will invest in other entities for the purpose of gaining exposure to the assets which are held by those entities; and
  - situations where a PDS states that a product will invest in other entities as investments in their own right (i.e. without there being a specific intention to gain exposure to the assets held by those entities).
20. In the first scenario, the costs incurred by the vehicle must be included in the ICR. In the second scenario, the costs incurred by the vehicle can be left out of the ICR calculation.
21. One potential problem under this approach is that product issuers could achieve lower ICRs by changing the wording in their PDS. Two products with identical investment strategies and completely identical investment arrangements could potentially disclose different ICRs, simply because one has chosen different wording in its PDS. The Committee queries whether this is ASIC's intention.
22. Private equity funds are an interesting case in point. In the Committee's experience, very few PDSs state that the product invests in unlisted private companies and start-ups and that this is achieved by investing through private equity funds. It is more common to simply disclose that the product invests in private equity or alternative investments. Based on the current wording of the draft Class Order, most funds would be able to exclude the fees charged within private equity funds from their ICRs. Again, the Committee queries whether this is ASIC's intention.
23. As a general observation, paragraphs (c)(i) and (c)(ii) are very difficult to interpret and it would assist if the drafting were to be simplified.
24. More broadly, however, the Committee queries whether it is right to be focussing on the reasonable beliefs of readers of the PDS. ICRs are calculated by or on behalf of trustees (typically by personnel in the finance division or by an external firm) and trustees are best placed to form a view on whether particular investments were intended to be investments in their own right or whether they were intended to be conduits and a means of gaining exposure to the underlying assets. In practical terms, the personnel within the finance division of a trustee are not in a position to form a view on how a reasonable reader may or may not have interpreted the PDS.
25. The Committee therefore queries whether a better approach would be to focus on whether or not the substantial purpose of investing in an entity was to gain exposure to the assets held by that entity – in other words, the focus should be on what the product issuer was intending, rather than on what a reader gleaned from the PDS.

## Exception for investments made by non interposed vehicles

26. Paragraph (d) of the new definition seems to create an exception for downstream investments by other vehicles which are not interposed vehicles because they have already qualified under the exceptions in paragraphs (a), (b) or (c) of the new definition.
27. We query whether this is necessary, because presumably the look-through for ICR purposes is broken at the point where the investment chain includes an entity which is not an interposed vehicle.
28. However, what is missing is an exception for downstream investments made by entities which are interposed vehicles. For example, consider an investment by a superannuation product in an ETF for the purpose of gaining exposure to the underlying securities. It is necessary to clarify that not all costs incurred by entities in which the ETF invests need to be included in the superannuation product's ICR.

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## Definition of indirect costs

### Inconsistent treatment of superannuation products and managed investment products

29. Until about a year ago, ICRs were calculated identically for superannuation products and managed investment products. This was appropriate because it was logical, consistent, symmetrical and because many retail clients compare:
  - the costs of investing voluntary contributions via their superannuation fund with the costs of investing those amounts outside of the superannuation system through a managed investment product; and/or
  - the costs of investing their preserved benefits via their superannuation fund with the costs they would incur if they established a self-managed superannuation fund and then invested in managed investment products.
30. However, recent modifications to Schedule 10 of the Corporations Regulations, together with the draft Class Order, are creating differences in how ICRs are calculated for superannuation products and managed investment products.
31. The definitions of “indirect cost ratio” and “indirect costs” mean that superannuation products are at a competitive disadvantage in so far as they must comply with broader definitions than those which apply to managed investment products, resulting in the appearance of higher ICRs for superannuation products.
32. For example, the effect of clauses 102(2)(b) and 103 of Schedule 10 is that managed investment products do not have to include brokerage and stamp duty in their ICRs, whereas superannuation products must. The Committee queries whether this was an unintended consequence of changes to the drafting which were merely or mainly intended to import the language of the Stronger Super and MySuper reforms.
33. Similarly, the Committee queries why the draft Class Order is proposing a new definition of “indirect cost” which allows managed investment products (but not superannuation products) to exclude certain costs associated with derivatives – see draft clause 101A(4) of the proposed new definition of “indirect cost”.

### Treatment of derivatives

34. Derivatives are singled-out for specific treatment and, on the face of the drafting, the attention given to buy-sell spreads on derivatives appears disproportionate to the extent of any perceived mischief concerning the disclosure of those costs.
35. Buy-sell spreads would likely only ever be a small part of the ICR and there are other more significant components which are not dealt with in the same level of detail.
36. If ASIC’s intention is to clarify when buy-sell spreads on derivatives are (and are not) to be included in the ICR, perhaps it would be more efficient to include this elaboration in a regulatory guide or website FAQ.
37. The proposed new clause 101A(3) states that the buy-sell spread incurred when acquiring or closing-out an OTC derivative must be included in the ICR. By implication, this suggests that buy-sell spreads when acquiring or closing-out exchange traded derivatives do not need to be included in the ICR.
38. We query why buy-sell spreads on exchange traded derivatives should be treated differently from buy-sell spreads on OTC derivatives.
39. With regard to managed investment products, the effect of clauses 102(2)(b) and 103(b) of Schedule 10 is that buy-sell spreads are specifically excluded from the ICR calculation. It is therefore questionable whether the proposed new clause 101A(3) would be effective, since it is inconsistent with a specific exclusion included in Schedule 10 itself.
40. On the other hand, the proposed new clause 101A(4) allows managed investment products (but not superannuation products) to exclude buy-sell spreads and other

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transactional costs associated with derivative transactions which were undertaken for hedging purposes. The Committee queries why this is necessary, having regard to the effect of clauses 102(2)(b) and 103(b) of Schedule 10 which already exclude buy-sell spreads and transactional costs from the ICR for managed investment products. However, to the extent it is necessary to create this exception, the Committee queries why it should not equally apply to superannuation products.

### **Past tense or future tense**

41. Anecdotally, there is a misperception that the new definition of “indirect cost” will require product issuers to make forward-looking estimates about the costs that they and their interposed vehicles will incur, including performance-based fees.
42. However, this is not (and should not be) the case. The ICR is inherently a backward-looking number which is only ever calculated and disclosed for the most recently completed financial year.
43. To avoid such confusion and ambiguity arising, the proposed new clause 101A(1) should be drafted in the past tense. The drafting should not be focussing on amounts which “**will** directly or indirectly reduce the return”. Instead, the focus should be on amounts which “directly or indirectly reducedd the return” and so forth.

### **Residual double-counting issue**

44. The so-called double-counting issue arose because:
  - Some amounts which were already included in the ICR (because they were required to be) also had to be disclosed as investment fees or administration fees; and
  - Some amounts which were already disclosed as investment fees or administration fees (because they were required to be) also had to be included in the ICR.
45. The proposed new clause 101A(1)(b) only deals with the second of these issues. The new clause states that the ICR only includes amounts which have not been charged as an investment fee or administration fee (i.e. amounts which have been disclosed as investment fees or administration fees can be excluded from the ICR).
46. However, what is missing is a clear statement that “investment fees” and “administration fees” do not have to include or disclose amounts (or categories of amounts) which were included in the ICR.
47. Note that the issue of past tense and future tense arises here also. The disclosure of investment fees and administration fees is done on a forward looking basis (i.e. what will be charged in future), whereas the ICR is backward looking (i.e. what was charged during the last completed financial year). The drafting would need to reflect this subtlety.
48. It should also be noted that some superannuation products have charging structures which include a combination of dollar-based and percentage-based fees and charges. For example, the administration costs might be \$x plus a further indirect charge of y% per annum. In the Committee’s view, what is most important is that members are informed of both components of the administration charge. This principle can be honoured while allowing product issuers flexibility to choose whether:
  - to disclose the percentage-based component alongside the dollar-based component as an administration fee; or
  - to disclose only the dollar-based component as the administration fee and instead include the percentage-based component in the ICR – which is what the current drafting seems to require.
49. This flexibility could be created by changing the drafting of the proposed new clause 101A(1)(b) as follows: “is not charged or otherwise disclosed to a member as a fee”.
50. That said, an issue arises where a charge levied by the product issuer has been increased since the completion of the last financial year. In this situation, disclosing

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the charge as part of the ICR would result in the (lower) historical fee being disclosed, even though the issuer would know that the charge for the financial year ahead will be higher. In contrast, disclosing that component as part of the administration fee would require the product issuer to disclose the (higher) fee that will apply going forward. ASIC may wish to consider the disclosure implications in this scenario.

## Technical issues for pension products

51. As noted in an earlier Law Council submission prepared by the Committee, a pension product cannot be a MySuper product. In addition, a pension product does not have insured benefits.

52. Therefore Schedule 10 of the Corporations Regulations should be modified as follows.

- Item 201 should be amended to insert a pension-specific fee template (and preamble wording) for pension products that does not include references to 'insurance fees' and a 'MySuper product'.
- Item 210 should be amended to insert a pension-specific annual example that does not include references to a 'MySuper product'.
- Item 220 should have a new subclause 220(3) inserted that specifically allows the example for a pension product to be based on the default option for the pension product or if there is no default option, the investment option under which most of the assets attributable to the pension product are invested.
- The consumer advisory warning in item 221 should have a new subclause 221(3) for pension products that omits the reference to 'Your employer' and replaces it with 'You'. (This may also require consequential amendments to proposed clause 222.)
- Item 301 should also be updated so as to harmonise the description of indirect costs which must be included in periodic statements with the proposed new expanded definition.

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## **Attachment A: Profile of the Law Council of Australia**

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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 2014 Executive are:

- Mr Michael Colbran QC, President
- Mr Duncan McConnel President-Elect
- Ms Leanne Topfer, Treasurer
- Ms Fiona McLeod SC, Executive Member
- Mr Justin Dowd, Executive Member
- Dr Christopher Kendall, Executive Member

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