

Submission

Draft regulations and example product disclosure statement for managed investment schemes that invest mainly in financial assets

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1. About McMahon Clarke Legal

McMahon Clarke Legal is a specialist commercial law firm with expertise in financial services and funds management. Our clients include a large number of fund managers who operate and promote a variety of managed investment products.

More information about McMahon Clarke Legal can be found at www.mcmahonclarke.com.

2. Objectives

We welcome the opportunity to make a submission to the Commonwealth Treasury (Treasury) on the draft *Corporations Amendment Regulations 2009* (Regulations) and example product disclosure statement (Example PDS) for managed investment schemes that invest mainly in financial assets which was released on 21 December 2009.

The objectives of our submission are as follows:

- (a) To raise some issues we consider flow from the proposed Regulations and their application and, where appropriate, to provide suggestions to Treasury.
- (b) To seek further guidance from Treasury in relation to certain issues.

We have outlined our general comments in section 3 and have included more particular comments in relation to the Regulations, as they appear, in section 4. We have also included our comments on the interaction between the Regulations and the existing law in section 5.

3. General comments

3.1 Interaction between the Regulations and the existing law

We understand the Treasury is aware there may be interactions between the Regulations, existing provisions of the *Corporations Act 2001* (Act) and the *Corporations Regulations 2001* which may need further consideration and amendment as a result of the Regulations. In particular, we note the Treasury has highlighted sections 1013FA, 1013H, 1013I, 1013J, 1016C, 1016D and 1016E of the Act need further consideration. We consider there are further provisions of the Act which will require amendment as a result of the Regulations and some of these have been discussed in section 5.

3.2 Transitional arrangements

We note the Treasury is yet to publish guidance on the proposed transitional arrangements for the Regulations. We would strongly suggest that registered managed investment schemes which are currently in operation not be subject to the Regulations until they prepare and issue new disclosure documents.

3.3 Effect of disparate disclosure documents

We are concerned about the effect of different disclosure regimes applying to different sectors of the investment community. In particular, we question whether those products that are not of the kind which must comply with the Regulations may appear more complicated and riskier to investors simply because of the content (and size) of their disclosure documents.

3.4 Definition of financial asset

We note the definition of "financial asset" has yet to be finalised. We have assumed for the purposes of our submission the definition will be similar, if not the same, as that applied by the Australian Securities and Investments Commission (ASIC) in *Pro Forma 209—Australian financial services licence conditions*. However, we assume the Regulations are not intended to cover managed investment schemes, which may, in an establishment phase or upon sale of assets, for example, hold at least 80 percent of their assets in financial assets, but which intend to hold assets other than financial assets for the majority of the term of the scheme.

4. Draft Regulations

4.1 Proposed subregulation 1.0.02(1)

Our comments are as follows:

- (a) It is not clear what is intended by subparagraph (1)(c)(i). Perhaps the intention would be clearer if the subparagraph referred to the acquisition of "an interest" in a registered management investment scheme, rather than the acquisition of "registered managed investment scheme" itself. As currently drafted, the subparagraph is not commensurate with the similar provisions in subparagraph (1)(a)(i) and (1)(b)(i).
- (b) We recommend that the word "closure" in subparagraph 1(c)(ii) is replaced with "winding up" given that the word "closure" is not a term that is used in the Act.

- (c) We query what fees and costs Treasury envisage will not relate to the "ordinary acquisition", "operation" or "closure" of a managed investment scheme for the purposes of paragraph (1)(c). For example, is the cost of trading in the underlying assets a cost which relates to the "operation" of the managed investment scheme?

4.2 Proposed regulation 7.9.11X

We consider the incorporation by reference provisions should provide for incorporation via websites in more explicit terms. For example, we consider subparagraph 7.9.11X(3)(a)(iii) could be amended as follows:

"publicly available in a document or other easily accessible public place, such as a website, other than the Statement".

4.3 Proposed regulation 7.9.11Y

We note subregulation 7.9.11Y(3) refers to paragraph 7.9.11P(3)(c). We believe this reference should be to paragraph 7.9.11X(3)(c).

4.4 Schedule 10E—Minimum content

- (a) We query why a table of contents is required for what might be a six page document.
- (b) The statement in paragraph 2(b) should refer to a person who is considering investing in the registered managed investment scheme, rather than to a person who actually invests.
- (c) The mandatory warning contained in subparagraph 3(a)(i) assumes every issuer will take advantage of the incorporation by reference mechanism in the new regulations.

4.5 Schedule 10E—Contents of section 1

- (a) The statement in subparagraph (1)(a) does not provide for non-cash contributions.
- (b) Why is it necessary to describe *all* of the products issued by the responsible entity (as per subregulation (2)(b)) if they are not relevant to the product disclosure statement (PDS)?

4.6 Schedule 10E—Contents of section 2

- (a) Does the statement in paragraph (2)(a) require a summary of the minimum investment amount for each scheme the subject of the PDS or does it just

require the lowest minimum investment amount for a scheme which is subject of the PDS as per the example PDS?

4.7 Schedule 10E—Contents of section 3

- (a) We request clarification on what type of information Treasury envisages will be included pursuant to paragraph (1)(c).
- (b) We query whether the information to be provided pursuant to paragraph 2(a) will be the same as, or sufficient to satisfy, that required by section 1013DA of the Act. If so, we would suggest the application of section 1013DA to such managed investment schemes should be omitted in the Regulations.

4.8 Schedule 10E—Contents of section 4

- (a) We query the value of including generic risks of investing in managed investment schemes, and not specific risks associated with the managed investment schemes the subject of the PDS.
- (b) We suggest regulation (5) be amended by removing the word "significant" so responsible entities are able to incorporate any risk information by reference which they consider is appropriate to disclose and that these risks include risks specific to the managed investment schemes the subject of the PDS and not just the generic risks "of registered managed investment schemes".

4.9 Schedule 10E—Contents of section 5

- (a) This regulation assumes that all PDSs which are required to comply with these regulations will contain more than one investment option. This will not always be the case as some PDSs will only contain information about one managed investment scheme.
- (b) We query the intended application of paragraph (3)(d). Is it intended that all investment returns are expressed as a return above the consumer price index (CPI) or is it intended that where a product return is benchmarked against the CPI an explanation of CPI is included? We strongly object to prescribing CPI as the standard benchmark for all products, as the appropriate benchmark will vary depending upon the particular product and investment manager. If it is the latter, we suggest paragraph 3(d) is amended to clarify this is the requirement.
- (c) From our previous experience on such issues, we know ASIC considers that quoting investment return objectives without appropriate consumer

warnings is potentially misleading and deceptive. Our product issuer clients have received interim stop orders from ASIC on this point in the past where the investment return objective has been—

- (i) quoted without sufficient warning that it is a target and not a guarantee of performance, and
 - (ii) displayed in a prominent position within the PDS.
- (d) We note paragraph 3(f) requires the risk level of the product be disclosed and the example PDS includes risk summaries such as "medium to high". We would suggest that inclusion of such a generic risk description adds little value to investors. We would suggest if meaningful information is to be provided to investors, responsible entities should be required to give a summary of the risk level compared to similar products, such as "this product is a higher risk product than a fixed interest product but is lower risk than an international equities product. As such, we consider this product is medium risk." Such disclosure would allow comparability between registered managed investment schemes which invest in different underlying assets.
- (e) We seek clarification on the point in time at which the responsible entity will be required to determine "the investment option under which the entity has the most funds invested" pursuant to subregulation (5).
- (f) Paragraph 7(a) assumes there will always be more than one product on offer. We also consider subregulation (7) is slightly ambiguous. It is not clear whether it is mandatory to include a link to the information referred to in paragraph 7(a) and paragraph 7(b) or the information itself.

4.10 Schedule 10E—Contents of section 6

- (a) We note paragraph (1)(a) refers to "acquiring the balanced option". However, we suggest that for the purposes of clarity this should refer to the cost of acquiring "an interest" in the balanced *investment* option (being the term used in item 101 of Schedule 10).
- (b) We seek clarification on what Treasury considers the "main fees and costs" of the investment will be (in this regard we note our comment in section 4.1(c) in relation to the definition of "minor fee").
- (c) We question why not all fees and costs should be disclosed in the table required in paragraph 4(a) when the purpose of the Regulations is to enable a "summary of all of the key information" and to "help ensure

comparability amongst products"¹. Similarly, we question why details of how performance fees are to be calculated are not required to be included under subparagraph (4)(d)(iii). We consider fee disclosure is a key investor consideration in acquiring a product and we believe full disclosure should be required in order to promote meaningful comparability.

- (d) In relation to paragraph (2)(a), as discussed in section 4.9(e), we seek clarification as to whether there is a point in time at which this should be determined by a responsible entity and what the consequences may be when the identity of the relevant fund changes.
- (e) The maximum fees are generally set out in the constitution for the managed investment scheme and then the actual fees are set out in the PDS for the offer of interests in the managed investment scheme. If the maximum fees set out in the constitution are not charged, then why should they be disclosed in the PDS if the reality is different? Why not maintain the existing arrangements so that the maximums are disclosed, but what investors are actually charged is contained in the table?
- (f) The mandatory statement required by paragraph 7(a) is misleading when the table does not contain all of the fees and costs an investor might be charged. The impact of performance and other fees should be taken into account by investors when making an investment decision. We submit it is impossible to compare two products based solely on the information required to be contained in the proposed fee table.
- (g) We question whether a term should be mandated for the purposes of the calculations in paragraph (8)(a) and paragraph 8(b). This would ensure comparability with the indirect cost ratio figure required in paragraph 8(d) and would also provide a useful benchmark for the many registered managed investment schemes which do not have a finite or specified life. We assume the benchmark for open schemes would be 80 years.
- (h) In respect of the worked example in subregulation 8, please consider the following:
 - (i) Is it intended that the registered managed investment scheme's overall cost is based on an annual average, or is it the aggregate

¹ *Commentary: Product Disclosure Statement for Managed Investment Schemes that invest mainly in financial assets* at paragraph 14.

cost over the scheme's lifetime, which, for most open schemes would be approximately 80 years?

- (ii) Is it intended the overall cost include the costs of winding up the fund, given it is intended to represent all the costs over the lifetime of a scheme?
 - (iii) Is the "average balance" based on gross or net assets of the scheme?
 - (iv) How would an issuer project the average balance over the life of the scheme?
 - (v) If the ICR is based on management costs then an estimate of performance fees will need to be included in the calculation. The table should state that the costs *include* an estimate of annual performance fees and that they are not excluded.
 - (vi) Are the quarterly instalments referred to in subparagraph (e)(ii) made on the first day of the quarter or the last?
 - (vii) Is the return referred to in subparagraph (e)(iv) calculated on daily balances? Does the reference in that paragraph to "before fees and costs" also include contribution fees that would be deducted on the day of further investment?
 - (viii) Based on the requirements of subregulation 8 and the information in the main fees and costs table of section 6 in the Example PDS, we calculated the costs to be \$25,682 (not "up to \$31,000" as per the Example PDS) with an overall cost of 1.82 percent per annum (not 1.7 percent per annum), based on the assumption that management fees are paid annually. Attached as a schedule to this submission are our workings. Please provide some clarity on how the worked example has been calculated and what assumptions have been made. For example, should management fees be deducted annually or quarterly? If comparability is the goal of these regulations, then the calculation of the costs of the fund must be absolutely clear for all issuers.
- (i) Unless a more prescriptive approach is taken with the fees and costs information, then the statement in paragraph (9)(a) should not be mandatory because it is unlikely to be true.

4.11 Schedule 10E—Contents of section 7

We note it is a requirement under paragraph (2)(a) that the responsible entity states it will not pay tax on behalf of members. However, this may not be true for certain managed investment schemes such as trading trusts.

4.12 Schedule 10E—Contents of section 8

An explanation of a cooling-off period should only be required if one applies to the particular fund. This will not always be the case.

5. Application of the Act

- (a) Section 1015B of the Act requires that a copy of a PDS must be lodged with ASIC in particular circumstances. We query whether this provision will be satisfied by a responsible entity lodging a copy of the PDS only or whether the information which is incorporated by reference must also be supplied.
- (b) We query how the incorporation by reference power in the Regulations will operate for existing provisions of the Act if only particular information, as specifically empowered by the Regulations, is able to be incorporated as provided for in subregulation 7.9.11X(2). For example, while the Regulations provide for incorporation of particular, specified pieces of information, there is no incorporation by reference power for other pieces of information, such as those which are currently provided for in the Act. We consider either the Regulations or modified subsection 1013C(1) and subsection 1013C(2) should be expanded to allow incorporation by reference power of such other pieces of information.
- (c) Section 1016A of the Act provides that a responsible entity may only issue or sell a managed investment product where the application form used was included in, or accompanied, a PDS that was given to the applicant. We query the application of this section of the Act if the Regulations are introduced. In particular, further to our comments above in paragraph 5(b), we can find no power in the Regulations which allows incorporation by reference of an application form. There is also no provision in the Regulations for such a form to be included in, or accompany, the PDS.
- (d) In addition to the particular sections outlined above and those highlighted by Treasury, we question whether a number of existing sections in the Act will operate effectively with the Regulations. In particular we suggest

further consideration is given to the omission or incorporation by reference of the following sections 1013DA, 1013F, 1013G, 1013M.

6. Conclusion

While we support the initiative to streamline and simplify disclosure for managed investment products, if the Treasury's objective is to promote comparability, then further work is required to ensure the regulations are clear in their application. We also have some concerns about the potential inconsistencies between the Regulations and the Act.

We look forward to working with Treasury on streamlined and simplified disclosure for managed investment products. Please contact Chris Mee from McMahon Clarke Legal on 07 3239 2961 to discuss any aspect of this submission.

Schedule 1—Calculation of the worked example

Initial Contribution **100,000**
 Ongoing Contribution **1,250** per quarter
 Estimated Rate of Return **5.00%**
 Initial Contribution Fee **3.00%**
 Ongoing Contribution Fee **3.00%**
 Management Fee **1.50%** (based on net value of investment)
 Withdrawal Fee **0.20%**

Example

	Year 1				Year 2				Year 3				Year 4				Year 5				Year 6				Year 7				Year 8				Year 9				Year 10				TOTAL
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Contributions																																									
Initial Contribution	100,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	100,000	
Ongoing Contribution	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	50,000	
	101,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	1,250	150,000		
Contribution Fees																																									
Initial Contribution Fee	3,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	3,000		
Ongoing Contribution Fee	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	1,500	
	3,038	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	38	4,500	
Net Contribution	98,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213	145,500		
Earnings (9% on cont. post cont. fees)																																									
Estimated Return	1,228	1,258	1,289	1,320	1,332	1,364	1,396	1,429	1,440	1,473	1,507	1,541	1,552	1,586	1,621	1,657	1,667	1,703	1,740	1,777	1,787	1,824	1,862	1,901	1,911	1,950	1,989	2,029	2,062	2,103	2,145	2,187	2,196	2,239	2,282	2,325	2,334	2,379	2,423	2,469	72,276
Other Fees																																									
Management Fees	-	-	-	1,604	-	-	-	1,736	-	-	-	1,872	-	-	-	2,013	-	-	-	2,159	-	-	-	2,310	-	-	-	616	-	-	-	2,657	-	-	-	2,825	-	-	-	3,000	20,791
Withdrawal Fee	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	391
	-	-	-	1,604	-	-	-	1,736	-	-	-	1,872	-	-	-	2,013	-	-	-	2,159	-	-	-	2,310	-	-	-	616	-	-	-	2,657	-	-	-	2,825	-	-	-	3,391	21,182
Cum. Bal at End of Quarter	99,440	101,911	104,412	105,341	107,885	110,462	113,070	113,975	116,628	119,313	122,032	122,914	125,678	128,476	131,310	132,166	135,046	137,962	140,914	141,744	144,744	147,781	150,856	151,660	154,783	157,945	161,147	163,773	167,048	170,364	173,721	174,463	177,872	181,323	184,817	185,529	189,076	192,667	196,303	196,594	
Total Fees	3,038	38	38	1,642	38	38	38	1,773	38	38	38	1,909	38	38	38	2,050	38	38	38	2,196	38	38	38	2,347	38	38	38	654	38	38	38	2,694	38	38	38	2,863	38	38	38	3,428	25,682
Yearly Average																																									
Average Overall Cost p.a.																																									1.80%
																																									1.82%

Note: Above calculation assumes management fees are only paid once a year, not quarterly.