

# Costs

## 4.1 Introduction

There are two sides to the issue of costs. On the one hand, there is the cost of investing in a managed investment scheme, which includes entry, exit and ongoing management fees borne by scheme members. On the other hand, there is the cost of operating a scheme, including the cost of complying with relevant legislation, which is borne in the first instance by the scheme operator. Of course the two aspects are intimately related. The cost of operating a scheme will be reflected in the fees charged to investors and/or the returns they receive on their investment. Competitive pressures also have the potential to influence costs, as they may lead to scheme operators absorbing some of the costs they might otherwise pass on, in order to build or maintain a market presence.

A great deal of attention was focussed on costs during the debate and passage of the MIA. Proponents of the new arrangements claimed that substantial cost savings could be achieved by the replacement of the dual trustee/fund manager structure with a single RE, and that this would translate into lower fees and charges for investors. Critics of the MIA were equally adamant that the compliance arrangements would not only offset any cost savings from the removal of the dual structure, but would increase ongoing costs. They also pointed to the cost of transitioning to the MIA regime.

It is likely that both sides of the debate over-played the impact on costs, particularly given the difficulty in obtaining consistent and comparable quantitative evidence. This is due to a number of factors — most importantly, the lack of a single parameter that serves as a reliable indicator of the cost of investment. Although management expense ratios (MERs) are often taken as a proxy of the cost of investing, they rarely encompass the full range of fee and charge structures in a managed scheme. This leads to difficulties in making comparisons between schemes, and even within the same scheme over time.

A related difficulty is attempting to disentangle the 'true' cost of investing from other factors that impact upon managed schemes. Up until relatively

recently, the financial sector had been growing particularly strongly, and as a result, there had not been a major catalyst for a large-scale rationalisation of costs within the investment industry. That said, while conditions have been buoyant, the competition within the industry has acted to ensure that the effect of extraneous factors, such as the Y2K 'bug', has been relatively muted. However, such factors add to the difficulty in making a definitive statement on whether costs have risen or fallen as a result of the implementation of the MIA.

## **4.2 Costs cannot be considered in isolation**

A theme that runs throughout this report is that the central aspects of managed investments are interrelated, and cannot be viewed in isolation. Costs are a particularly good example of this interrelationship, being closely connected with issues of compliance, competition, consumer choice and investor protection.

Even if it could confidently be said that the cost of investing had risen or fallen under the MIA, this alone would not reveal a great deal. A decrease in costs is of little benefit if it comes at the expense of reduced investor protection. Likewise, an increase in costs due to compliance requirements may be justifiable if there have been improvements in the management and administration of schemes, which has enhanced investor protection.

It is felt that undue emphasis may have been given to costs, by both sides of the debate, during the development and implementation of the MIA, and not enough attention focussed on the integration of costs with other aspects of investing in a managed scheme.

## **4.3 Analyses of costs**

Despite the concerns expressed earlier about the difficulties in reaching a definitive view on the effect on costs flowing from the introduction of the MIA, it is nevertheless instructive to consider the studies that have been conducted in this area.

The submission from the Investment and Financial Services Association Limited (IFSA) included a report on Retail Registered Schemes Fees and

Charges.<sup>1</sup> The report found that, for the period 1996 to 2000, there had been an overall reduction in the weighted average MER of 3.92 per cent (or 6 basis points), translating to an annual cost saving of approximately \$53.3 million. From the commencement of the MIA on 1 July 1998, the report found an overall reduction in the weighted average MER of 2 per cent (or 3 basis points), translating to an annual cost saving of \$26.8 million.

The report acknowledged that the available data did not permit a quantitative analysis of access and advice fees, due to a number of factors which influenced the exact entry fee paid by an investor, such as rebates provided by an investment adviser. Nevertheless, the report concluded that over the period studied, the potential cost to an investor had reduced due to widespread rebating by fund distributors and the evolution of low-cost distribution channels such as discount brokers.

While these findings are encouraging, they raise the obvious question of whether the cost reductions arose as a result of the implementation of the MIA, or whether they would have occurred in any event. In this regard, it is apparent from the report findings that costs were trending downward prior to the MIA's introduction.

The submission from the Australian Consumers' Association (ACA) questioned whether cost savings had eventuated, noting that it had considered fee statistics for several Australian equity funds over the period in which the transition to the MIA took place.<sup>2</sup> While acknowledging that the funds selected did not constitute a representative list, the ACA considered that the statistics showed that fees had not been significantly reduced during the transition from the dual trustee/fund manager structure to a single RE.

The ACA suggested that this Review of the MIA should consider, on the basis of independent research, the movement in MERs and fees generally for investors in the transition to the MIA regime.

It was not seen as the role of this Review to commission research into fees. However, it is noted that at least one independently funded body, the Centre of Corporate Law and Securities Regulation (CCLSR), which is part of the

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1 Prepared for IFSA by KPMG.

2 Using data from Morningstar, the ACA considered MERs for selected Australian equity funds (data for 2001 was not available).

University of Melbourne, is currently conducting research into the governance of managed investment schemes, including the collection of information on the costs of implementing the mandatory compliance structures required under the MIA.<sup>3</sup> At the time of printing of this report, the CCLSR had not yet reported its findings.

## 4.4 Measures to reduce costs

Although it cannot be stated categorically that the costs of investing in managed investment schemes have fallen as a result of the introduction of the MIA, there are nevertheless options to consider that may reduce the costs of complying with the MIA, and which do not detract from investor protection.

### 4.4.1 Differential fees

An area which has the potential to deliver fee reductions for certain investors relates to the ability of REs to offer different fee structures to members of managed schemes. Presently the legislation provides that the RE of a registered managed investment scheme must treat members who hold interests of the same class equally, and members who hold interests of different classes fairly.<sup>4</sup> To date the ability of REs to charge differential fees has been severely limited by the use of the word *equally* in the legislation, which ASIC has correctly interpreted as largely preventing such arrangements.

Earlier this year ASIC published a Class Order<sup>5</sup> providing relief from the equal treatment provisions to enable limited differential fee arrangements. That Class Order generated a number of submissions to ASIC seeking extensions to the permitted categories of differential fee arrangements. Submissions to this Review have similarly suggested that differential fee arrangements be liberalised.<sup>6</sup>

In a supplementary submission to the Review ASIC noted that the requirement to treat members of the same class *equally* made it difficult to appropriately consider differential fee arrangements, and suggested it may be preferable if the requirement was made more flexible, such as a requirement to treat

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3 The CCLSR project is funded by the Australian Research Council.

4 Paragraph 601FC(1)(d).

5 Class Order 01/50, 17<sup>th</sup> January 2001.

6 Commonwealth Bank of Australia, Freehills, Minter Ellison and IFSA.

members of the same class *fairly*, as already applies in respect of members of different classes. However, ASIC did not advocate a simple replacement of the equality test with a fairness test.

Rather, ASIC considered that any changes should be subject to certain requirements. Firstly, investors need to be provided with adequate disclosure so that they are able to compare the effect of differential fee arrangements, both between different fee structures offered by the same offeror, and among different offerors. This is supported.

The FSRA, which takes effect on 11 March 2002, amends the Corporations Act to implement new requirements in relation to the disclosure of fees and charges relating to financial products, which include interests in managed investment schemes. Disclosure of the type suggested by ASIC is entirely consistent with the objectives of the FSRA, and to the extent that any additional disclosure requirements are considered necessary as a result of a change from an equality test to a fairness test, they could be accommodated under the FSRA framework.

Secondly, ASIC suggested that it may be necessary that fairness be interpreted by reference to some economic justification. For example, a differential fee arrangement must be reasonable having regard to the difference between the cost incurred by the RE in providing services to any member who is a party to a differential fee arrangement, and the cost incurred in providing services to any member who is not a party to the arrangement. ASIC further suggested that imposing a disclosure requirement in relation to this measure might also be an effective regulatory tool. While not necessarily objecting to this aspect of ASIC's proposal, further consideration needs to be given to whether this measure is warranted and, if so, how best to implement it.

The question of what is fair will naturally be open to interpretation. Examples of fair differential fee arrangements might include:

- fees based on a difference in service (such as higher fees charged for the provision of additional member statements); or
- lower entry fees charged to a member making a very large investment, on the basis that the investment enables the scheme to take advantage of economies of scale, resulting in overall lower fees for all members.

An example of an unfair differential fee arrangement might arise where a RE offers lower fees to a related party on a totally arbitrary basis, with no benefit to other scheme members.

Between these fairly obvious examples, there are likely to be many grey areas, but this should not deter efforts to provide further guidance on this issue.

ASIC proposed that further discussion be held on whether interpretational assistance to a fairness test should be included in the legislation itself or in ASIC policy.

The issue of differential fees is not a new one, and ASIC and the industry have already engaged in extensive dialogue about it. Nevertheless, industry should be given an opportunity to consider the proposals put forward by ASIC in its supplementary submission. Therefore, ASIC's suggestion that further discussion take place is supported, not only in relation to where interpretational material relating to the fairness test should be located, but also as to the nature and content of that material.

#### **Recommendation 15**

- The requirement in paragraph 601FC(1)(d) that members holding interests of the same class be treated equally should be replaced with a requirement that such members be treated fairly, in respect of the charging of differential fees, subject to the requirement that investors are provided with adequate disclosure to allow them to compare the effect of differential fee arrangements.
- Further consideration should be given to whether there is also a need for the fairness 'test' to be interpreted by reference to some other criterion such as economic justification, and whether any interpretational material supporting the fairness test should be located in legislation or in ASIC policy.

#### **4.4.2 Scheme registration — registering multiple trusts/schemes as a single scheme**

Some submissions raised as an issue the circumstances in which a number of trusts or schemes may be registered as a single managed investment scheme,

rather than requiring individual registration.<sup>7</sup> It was argued that this would have an impact on costs, given that scheme registration attracts a fee.<sup>8</sup> The submissions suggested that ASIC has shown some reluctance to register several trusts or schemes as a single scheme.

A recommendation was made in Chapter 3 regarding the lodgement of 'model' compliance plans and scheme constitutions. It is considered that this initiative may provide some modest cost savings for REs. However, that recommendation is subject to REs continuing to assess the adequacy and appropriateness of compliance plans and constitutions on an individual scheme basis. Therefore, it does not follow that the use of model compliance plans and constitutions can be taken to imply that the schemes or trusts that make use of such models are so closely related that they can be considered a single scheme.

ASIC has noted<sup>9</sup> that it is administratively impractical to regulate arrangements based on whether a scheme promoter subjectively envisages several trusts as part of the one scheme, and considers there may be a loss of investor protection if a scheme constitution provides the ability to create additional unit trusts ad infinitum. It is agreed that this is an important consideration, and once again demonstrates the interrelationship between cost and investor protection.

ASIC suggested that either the definition of *managed investment scheme*<sup>10</sup> be amended to clarify that there must be a substantial degree of interdependence in the benefits to members in order for several trusts or schemes to be considered as one scheme, or that section 601ED relating to scheme registration be amended to provide ASIC with a power to determine when several trusts or schemes may be registered as one scheme. In the latter scenario, the explanatory material accompanying the legislative change would make clear that ASIC would exercise this discretion based on the degree of interdependence and economic relationship between the trusts or schemes.

It is accepted that an amendment to the legislation is warranted, in order to provide a more solid foundation on which decisions relating to registration of

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7 Minter Ellison and IFSA.

8 The current registration fee is \$1800 per scheme.

9 ASIC — part two.

10 Section 9.

multiple trusts or schemes can be made. Of the two options put forward by ASIC, the second is preferred, on the basis that it allows for greater flexibility. Persons whose interests are affected by ASIC's decisions should be able to apply to the Administrative Appeals Tribunal for a review of the decision.<sup>11</sup>

Regardless of which option is pursued, it will be necessary for some guidance to be provided as to what will constitute a substantial degree of interdependence between trusts or schemes. It is suggested that this is best done by way of ASIC policy, rather than legislative prescription, as the concept of interdependence may require tailoring, depending on the nature of the trusts or schemes involved.

It is acknowledged that differences of opinion will continue to arise between ASIC and promoters of schemes and their representatives in relation to the registration of multiple trusts or schemes as a single scheme. Nevertheless, it is felt that a more transparent statement of ASIC's discretion in this matter, coupled with guidance from ASIC as to how that discretion will be exercised, will provide greater certainty of approach, and assist in resolving any disputes that may arise. It is expected that this, in turn, will lead to some cost savings.

### **Recommendation 16**

Section 601ED relating to scheme registration should be amended to provide that where an applicant seeks to register more than one trust or scheme as a single scheme, ASIC may determine in writing that each trust or scheme must be registered separately.

- The explanatory memorandum accompanying this change should make clear that ASIC will exercise this discretion based on the degree of interdependence and economic relationship between the trusts or schemes;
- ASIC should issue policy guidance as to how it will exercise this discretion; and
- ASIC decisions should be subject to review by the Administrative Appeals Tribunal.

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11 Part 9.4A of the Corporations Act provides for AAT review of certain ASIC decisions, including those made under the managed investment provisions of Chapter 5C.

### **4.4.3 New responsible entities assuming obligations under contracts entered into by their predecessors**

Circumstances may arise where a new RE assumes permanent or temporary control of a managed investment scheme, and the new RE believes that the maintenance of existing obligations and liabilities to agents of the former RE may not be in the best interests of scheme members. This could, for instance, be an important consideration in situations where the scheme may be under financial strain due to maladministration by the former RE. In particular, inherited contractual arrangements may hinder the new RE in taking steps to reduce outlays, and return the scheme to financial viability.

Under the legislation, where the RE of a registered managed investment scheme is changed, the rights, obligations and liabilities of the former RE so far as they relate to the scheme, become the rights, obligations and liabilities of the new RE subject to certain limited exceptions.<sup>12</sup> Similarly, references to the former RE in documents under which it acquired or incurred a right, obligation or liability are taken to be references to the new RE.<sup>13</sup> Although the matter is not totally free from doubt, the preferred interpretation of the legislation is that the new RE 'inherits' contracts entered into by the former RE with an agent or other person appointed under subsection 601FB(2) to perform functions in connection with the scheme.

Two submissions to the Review argued that there should be scope for a new RE (including a temporary RE) to elect whether or not to assume the contractual obligations entered into by its predecessor.<sup>14</sup> Such contracts can operate to entrench the position of a RE, as onerous contractual obligations may deter entities from agreeing to take over the RE role. Thus, a RE can effectively frustrate the ability of members to replace it in cases where it may be underperforming. The potential for this situation to arise is perhaps greatest where the agents with whom the former RE has contracted are related to the former RE.

Nevertheless, the rights of parties who contract with a RE in good faith and at arm's length need to be considered. An unfettered right for a new RE to disinherit contracts entered into by its predecessor may deter entities from

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12 Section 601FS.

13 Section 601FT.

14 ASIC — part two, and a confidential submission.

contracting with REs in the first place, or lead to their seeking greater protection of their position, increasing the cost of the contract to the RE and, indirectly, the scheme members.

In July 2000, ASIC released for comment a draft Information Release<sup>15</sup> relating to this issue, in which it proposed draft Class Order relief to allow a new RE to avoid inheriting contracts made by the former RE with its agents. In particular, it proposed that the new RE could give an agent notice within one month after becoming RE that it did not wish to inherit the contract, whereupon the rights, obligations and liabilities under contracts made between the agent and the former RE would revert to the former RE. However, in the period between assuming the role of RE and giving notice to the agent, the rights, obligations and liabilities would rest with the new RE.

Another option put forward in the draft Information Release was that the new RE should be required to give notice to the agent before it becomes the RE, in which case the rights, obligations and liabilities under any contract with the agent would always remain with the former RE. The draft Class Order made it clear that the former RE would not have a right of indemnity out of the scheme property for liability to an agent due to the change of RE. The draft Class Order also specified that the right for a new RE to elect not to inherit contracts would not apply if the new RE was a related body corporate of the former RE.

ASIC did not proceed with the draft Class Order relief, partly no doubt in acknowledgement of the complex issues that arise in relation to the protection of the rights of agents who contract with REs.

Where contracts are entered into by an entity with a RE in the knowledge that the RE may be replaced, or where the contract is otherwise not made in good faith or at arm's length, there is a clear case to allow the new RE to elect not to take over that contract.

However, there may also be situations where it is not appropriate for the new RE to disinherit a contract with an agent of a former RE. For example, in the situation mentioned in ASIC's draft Class Order, where the new RE is a related body corporate of the former RE, it would be difficult to argue that the new RE should have a right to disinherit contracts, although the basis for this would be

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15 IR 00/23.

the relationship between the former and new REs, rather than an explicit recognition of the need to protect the rights of the other party to the contract.

The disinheritance of a contract by a new RE should not affect the validity of the contract as between the agent and the former RE, and the agent would still have rights against the former RE. Nevertheless, in many instances, a right of action under the contract (such as a claim for damages or specific performance) against the former RE will be of little value, for example, where the former RE is insolvent.

While in practice the removal of a RE should occur relatively infrequently, the issue of the inheritance of contracts has important ramifications which require detailed consideration. It is agreed in principle that new REs should, in some circumstances, have the right to elect not to inherit contracts relating to a managed investment scheme that were entered into between a former RE and its agents. However, further thought needs to be given to whether this should be an absolute right, or whether there are situations in which it is not appropriate for contracts to be disinherited. Therefore, it is suggested that further consultation take place between Treasury, ASIC and the industry to progress the matter.