CHAPTER 8

COSTS AND FEES

Introduction

8.1 In this chapter, the Committee considers whether the MIA has helped to reduce costs and fees in the managed investments industry. The Committee will then review the evidence on differential fees to decide whether legislative amendment would be desirable.

How has the MIA affected costs and fees?

8.2 In its chapter on costs, the Turnbull Review commented that:

> 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.
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> A related difficulty is attempting to disentangle the 'true' cost of investing from other factors that impact upon managed schemes…[W]hile conditions have been buoyant, the competition within the industry has acted to ensure that the effect of extraneous factors…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.[1]

8.3 In its current inquiry, the Committee sought to clarify the impact of the MIA on fees and to determine whether the strong growth in the managed funds industry in recent years, has been matched by an acceptable decrease in fees.

8.4 The importance of this issue is highlighted by the findings in the United States Securities and Exchange Commission's *Report on Mutual Fund Fees and Expenses*, released in December 2000 (SEC report) that apparently small increases in fees were shown to have quite significant and negative long-term ramifications for investors.

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1 Turnbull Review, pp. 75-6.

The study found that a 1 per cent increase in a fund's annual expenses could reduce an investor's end account balance in a fund by 18 per cent after 20 years.[2]

8.5 The Committee heard a range of views about costs and fees in funds regulated by the MIA. Some witnesses claimed that fees had trended downwards since the MIA's introduction, whereas others claimed fees had stayed the same or increased.

8.6 Most of the evidence was anecdotal with the exception of a statistical analysis of fees and charges across the Australian managed funds industry for the period 1996 to 2001 provided by the Investment & Financial Services Association Ltd (IFSA).[3]

8.7 The Trust Company of Australia Limited (TCAL) thought the MIA's impact on costs and fees varied according to fund size—for small funds, costs had increased while for large funds, there would be cost savings. Mr Jonathan Sweeney, Managing Director, TCAL, commented that:

> …our own internal experience on the funds management side is that it is costing us more, but we are managing only half a billion dollars. We are a smaller fund manager. It is most likely costing the big guys, who are managing $10 billion or $30 billion, less. But are they passing it on in fees?[4]

8.8 The Trustee Corporations Association of Australia (TCAA) claimed that, while proponents of the MIA had predicted the new regime would lead to cost reductions, there appeared to be no evidence that reductions attributable to the MIA had resulted in lower fees for investors. One reason for this, the TCAA suggested, was that REs were keeping the fees that, under the old regime, would have been paid to trustees. In addition, the TCAA questioned whether outsourcing by REs was negotiated on commercially acceptable, arm's-length terms. In this regard, the TCAA claimed that:

> …the absence of substantially lower fees reflects the fact that under the RE structure many activities of a scheme often are sub-contracted to related entities at prices that are higher than would apply through arm's length negotiations, and certainly higher than would be permitted if an independent entity acted as the investors' representative.[5]

8.9 According to Ms Lynn Ralph, IFSA's then Chief Executive Officer, costs had reduced since the introduction of the MIA. Ms Ralph cited the following passage from IFSA's report in support of this:

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2 The United States Securities and Exchange Commission, *Division of Investment Management: Report on Mutual Fund Fees and Expenses*, December 2000: www.sec.gov/news/studies/feestudy.htm (October 2002), p. 4.

3 *Retail Registered Schemes Fees and Charges: Second Release*, July 2002. (IFSA commissioned KPMG to prepare this report.)

4 *Committee Hansard*, 11 July 2002, p. 9.

5 Submission no. 3, p. 7.

> [KPMG's] analysis found that in the period following the implementation of the Managed Investments Act there has been a four basis point reduction in MERs. This reduction can be represented as producing a saving in fees for investors in 2000 and 2001 respectively of $35.7 m and $41.0 m…[6]

8.10 Referring to these figures, Ms Ralph commented that:

> We believe that this reduction in fees is significant, that it is growing and that it is consistent with the estimates which were made by our association prior to the enactment of the legislation.[7]

8.11 In response to the Committee's suggestion that fees had been falling since 1996, in other words, before the introduction of the MIA in 1998, Ms Ralph conceded this was so but argued that, as a general rule, managed investment ratios (MERs) had not risen since the MIA. In this regard, it said that:

> …across the industry it is difficult to get a real handle on what increased costs MIA might have had for managers, or whether they had any increased costs at all. We do know that we have not seen any increases in MERs as a result of that. So our suspicion is that, as a result of no increased costs, some savings or the preparedness of the manager to wear some increased costs in a competitive environment, at the bottom line the MERs have not ratcheted up in any way. So, yes, it is difficult to unpick where the change in the basis points has actually arisen, unless you were to unpick each manager's pricing, which is obviously a major task. But these are MERs of what is actually being charged in the marketplace today on a very large chunk of the retail funds that are out there.[8]

Start-up costs as a barrier to competition

8.12 Some of the evidence heard by the Committee suggested that the cost of meeting requirements under the MIA had discouraged smaller enterprises offering boutique services to enter the industry. It was argued that this would reduce competition in the industry and remove downward pressure on charges.[9]

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6 Committee Hansard, 12 July 2002, p. 26. Quoted from *Retail Registered Schemes Fees and Charges: Second Release*, July 2002, p. 1. (MERs generally measure the ongoing management costs of funds but do not factor in the full range of fees applying across managed funds, for example, entry and exit fees. However, in a recent report on disclosure of fees and charges in managed investments commissioned by ASIC, Professor Ian Ramsay commented that the MER 'provides useful information relating to relative costs across similar funds and can identify trends in relation to ongoing management charges and expenses over time. It is to be noted that similar operating expense ratios are used in other countries such as Canada, New Zealand and the United States…' (See Professor Ian Ramsay, *Disclosure of Fees and Charges in Managed Investments, Review of current Australian Requirements and Options for Reform,* 25 September 2002, p. 205.)

7 *Committee Hansard*, 12 July 2002, p. 27.

8 *Committee Hansard*, 12 July 2002, p. 28.

9 See, for example, submission no. 6A, p. 2.

8.13 In the absence of any statistical breakdown of fund sizes and number of players across the industry, the Committee heard anecdotal evidence only with regard to the effect of the MIA on competition within the industry.

8.14 Mr Sweeney, TCAL, said that the MIA had disadvantaged smaller operators and was creating market forces that would encourage further consolidation in the funds management industry which was not a good thing. In the TCAL's view, the MIA had raised barriers to entry causing new boutique managers to enter the wholesale rather than the retail market to escape regulation under by MIA. The upshot of this development, Mr Sweeney said, was that:

> …the large fund managers, who can afford the expensive set-up costs of the MIA and the expensive ongoing compliance costs, are safe from new and more nimble managers entering the retail market. At the end of the day, the consumer is definitely worse off…[10]

8.15 Mr Sweeney estimated that to set up a fully compliant single RE and fund structure would involve a start-up cost of approximately $200,000 and ongoing costs of at least $70,000 a year. Under the old regime, it was easier for newcomers to join the industry:

> …trustees acted for between three and seven basis points—that is, three to seven per cent of one per cent of gross assets and then there was usually a minimum fee of between $20,000 and $50,000. So you can see, it was much easier for a group to start up, because those set-up costs were not there. What they could do, effectively, was tap into the trustee companies' economies of scale. What we could do was leverage our economies of scale across all the start-ups.[11]

8.16 The TCAA shared the TCAL's view that start-up and ongoing costs imposed by the MIA had disadvantaged smaller players and was driving them into the wholesale sector. At the hearing on 12 July 2002, Mr Donald Christie, Managing Director, Equity Trustees Ltd (appearing with the TCAA), commented that this had the potential to reduce competition and favour major fund managers, 'because the ability to build the product that can be sold retail is not really there in the smaller end of the market'.[12]

8.17 When asked to comment on allegations that the MIA had raised barriers to entry, Ms Ralph, IFSA, queried whether there was actual statistical proof that there were fewer competitors in the industry. While acknowledging that there had been mergers between significant fund managers, Ms Ralph considered that there had been 'a whole raft of new players' entering the marketplace and 'a whole range of new boutiques.' Ms Ralph said that, for various reasons other than the MIA, developments

10 *Committee Hansard*, 11 July 2002, p. 4.

11 *Committee Hansard*, 11 July 2002, p. 4.

12 *Committee Hansard*, 12 July 2002, p. 52.

over the past 5 to 10 years had created new opportunities for wholesale boutique investment managers to enter the industry through platforms set up by large providers:

> [s]o we are now seeing more of those small managers pop up because they have the capacity to distribute their product in a way that did not exist 10 years ago.[13]

8.18 Ms Ralph said that 'any piece of regulation provides barriers to entry' and commented that:

> …under the old regime certain players found it difficult to find a trustee to act on behalf of their funds. Even now, some small groups choose appropriately, as envisaged by [the MIA] regime, not to be the responsible entity…Some groups choose that model and, similarly to the old regime, have a hard time finding a responsible entity.
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> There will always be some barriers but they have not stopped a lot of new boutiques from entering this marketplace and offering investment management services—any more, perhaps, than the old regime did.[14]

<u>The Committee's views</u>

8.19 Much of the evidence to the inquiry reflected a strong polarisation of views regarding the effect of the new regime on costs and industry structure. However, the Committee was not able to properly test this evidence given the absence of reliable, independent quantitative data.

8.20 While the data presented by IFSA indicated a downward trend in MERs, there was no hard evidence that this had translated into lower fees to investors or whether the downward trend could be attributed either wholly or in part to the changes introduced by the MIA.

8.21 The Financial Impact Statement in the Explanatory Memorandum for the MIA proposed that:

> In general, the anticipated cost to schemes of meeting procedural requirements of [ASIC] (such as licensing of the responsible entity, registration of a scheme, etc) are expected to be no greater than the cost of current analogous requirements.[15]

8.22 Contrary to the predictions of the explanatory memorandum, there appeared to be some consensus during the Committee's inquiry that the MIA had raised barriers

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13 *Committee Hansard*, 12 July 2002, p. 43. (In evidence to the Committee, Mr Paul Dortkamp also touched on the changes mentioned by IFSA. See *Committee Hansard,* 12 July 2002, p. 67.)

14 *Committee Hansard*, 12 July 2002, p. 43.

15 Managed Investments Bill 1997, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 9.

to entry in the funds management industry which had caused smaller players to opt for the wholesale rather than retail market.

8.23 The Committee is concerned that rationalisation in the industry should not reach an unacceptable level because of the effects this could have not only on fees, but also on investor choice and protection.

8.24 Professor Paul Von Nessen, Head of the Department of Business Law and Taxation at Monash University, recommended in his submission that a cost/benefit analysis comparing total economic costs incurred under the new system compared with its benefits should be conducted. He commented further that:

> It appears that analysis so far has concentrated only upon a comparison of the total costs absorbed by investors under the former and current system. I would hope that a more complete economic justification for the Managed Investments Act could be established through your review. A finding that [the Act] results in marginally lower fees than were charged under the prescribed interest system does little to validate the benefits of its enactment.[16]

8.25 The Committee agrees with Professor Von Nessen's assertion that a reduction in fees charged to investors, without additional benefits, is insufficient validation of the MIA. Furthermore, the Committee has serious concerns about the claims raised in evidence to this inquiry, namely, that the MIA has stymied competition within the industry.

8.26 Given the absence of any reliable, independent data on the subject, the Committee felt it was ill-equipped to draw any conclusions. The Committee would be particularly interested in information about the MIA's impact on costs and fees, competition and overseas investment in the industry.

Recommendation 14

The Committee recommends that the Government commission an independent cost/benefit analysis with a view to determining the impact of the *Managed Investments Act 1998* and other relevant legislation. This will then establish a useful benchmark for future studies. The analysis should specifically look at:

- **Australia's performance on costs and fees compared with major overseas financial centres;**
- **whether and to what extent the MIA has limited or stimulated competition within the industry; and**
- **whether understanding, transparency and disclosure for consumers has improved and/or is sufficient with regard to managed investments costs and fees.**

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16 Submission no. 12, p. 2.

8.27 The Committee notes that better disclosure by managed funds to enable an investor to compare fees, will promote competition within the industry. The Committee therefore commends ASIC's recent initiatives to improve disclosure of fees within the managed funds industry.[17]

Reducing costs and charges

Differential fees

8.28 At present, paragraph 601FC(1)(d) provides that the responsible entity must treat members holding interests of the same class equally and members holding interests of different classes fairly. ASIC's Class Order 02/214 grants relief, subject to adequate disclosure, from the equal treatment provision for some differential fee arrangements as follows:

- fees may be varied or waived for a member switching from one scheme to another scheme managed by the same RE;
- fees may be banded or tiered for investors based on the amount they have invested in a scheme or schemes managed by the RE; and
- fees may be negotiated with professional investors.[18]

8.29 In its submission to the Turnbull Review, ASIC commented that an amendment to the legislation to provide for the substitution of a 'fair' treatment in lieu of an 'equal' treatment criterion should apply only to accommodate differential fee arrangements. ASIC proposed in relation to the amendment that:

> …[the amendment] would need to provide a framework within which investors are provided with adequate disclosure such that they are able to compare, in a meaningful way, the effect of differential fee arrangements. We would be concerned if allowing greater use of differential fees were to result in making consumer comparisons of fees more difficult. We believe that this disclosure should deal both with the ability to compare different fee structures available from the one offeror and also the effect of differential fee structures as between different offerors. We note, for example, that in the United States, mutual funds are required to provide examples of costs, in dollar terms, over sample periods of time.
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> Secondly, ASIC believes that it would be necessary for any such amendment to provide additional constraints beyond those which the words 'fair' or 'fairly' might otherwise suggest. We believe that it may be

17 See ASIC Media and information release 01/352 *ASIC releases Ramsay Report on disclosure of fees and charges,* 25 September 2002. In this media release, ASIC announced the release of Professor Ian Ramsay's report, commissioned by ASIC, *Disclosure of Fees and Charges in Managed Investments, Review of Current Australian Requirements and Options for Reform.* ASIC said this report would 'facilitate further consultation by ASIC with industry and consumer representatives about the future direction of disclosure for investment products under the FSRA regime'.

18 Turnbull Review, p. 78.

> necessary that fairness be interpreted by reference to some economic justification; for example that a differential fee arrangement must be reasonable having regard to the difference between the cost incurred by the responsible entity 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. Imposing a disclosure requirement in relation to this requirement might also be an effective regulatory tool.[19]

8.30 At the hearing on 7 August 2002, ASIC confirmed the position taken in its submission to the Turnbull Review and commented that a legislative amendment to provide for a fairness test would 'remove the need for ASIC to deal with it by way of class order and allow the industry to proceed on a more secure basis'.[20]

8.31 Mr Russell Stewart, Partner, Minter Ellison Lawyers, commented that subsections 601GA(1) and (2) were open to the interpretation that the fees specified in a scheme's constitution could be maximum amounts thus allowing for variability at the RE's discretion. Mr Stewart said that ASIC appeared to read the provisions as referring to specific entry fees and management fees. He said that, not allowing an RE to exercise discretion, was causing fees to be higher than they otherwise would be. He cited the example, of an RE wanting to sell a product directly to the public as well as through an investment adviser. Where the RE was prepared to discount the entry fee for direct sales to the public, he said, it had to create a separate class of units for this purpose. This was an artificiality which 'create[d] accounting and reporting problems which seem to be unnecessary'.[21]

8.32 IFSA's views were similar to those expressed by Mr Stewart. IFSA considered that the equal treatment provision, as interpreted by ASIC, had adversely affected marketing in the industry, particularly where REs wanted to offer discounts to retail consumers. In its submission to the Turnbull Review, it commented that:

> IFSA strongly recommends that the equal treatment provision (section 601FC(1)(d)) be brought into line with the equivalent provision in the *Superannuation Industry (Supervision) Act 1993*. This would overcome the problems caused by ASIC's interpretation that entry and exit fees for schemes are part of the consideration to acquire interests and, therefore, subject to the equal treatment provision.

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19 ASIC's submission to the Turnbull Review, Part 2, pp. 1-2.

20 Mr Ian Johnston, *Committee Hansard,* 7 August 2002, p. 100.

21 *Committee Hansard*, 11 July 2002 p. 22. (Mr Stewart's evidence was given in a personal capacity and not as a representative of Minter Ellison Lawyers.) Paragraph 601GA(1)(a) says that the constitution of a registered scheme must make adequate provision for the consideration that is to be paid to acquire an interest in the scheme. Subsection 601GA(2) says, among other things, that any rights the RE is to have to be paid fees out of scheme property must be specified in the scheme's constitution.

> …ASIC's interpretation and policy leads to an inconsistency between investors who invest directly through the RE and those who invest via an intermediary…entry fees can be rebated…by an intermediary while a RE cannot waive or reduce fees for a retail investor who approaches them directly…[22]

8.33 Issues relating to differential fees have been included in the Department of the Treasury's consultation paper. At the hearing, the Department said it had not come to any decision about these issues.[23]

Recommendation 15

The Committee recommends that the *Corporations Act 2001* be amended to provide for a 'fair' treatment criterion in lieu of 'equal' treatment but only to provide for differential fees.

The Committee further recommends that what constitutes 'fair' treatment should be developed through consultation between the Department of the Treasury, ASIC and industry groups. The Committee notes that the Department is presently consulting with regard to this issue.

8.34 Several other proposals were made for reducing costs. These concerned more technical issues regarding the streamlining of registrations, particularly with regard to multiple trusts, and the use of model constitutions and compliance plans. The Committee notes these issues are included in the Department of the Treasury's consultation regarding the Turnbull Review and believes this is an appropriate forum for their consideration.

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22 Submission no. 2, Attachment 1 (submission to the Turnbull Review), p. 19.

23 *Committee Hansard*, 7 August 2002, p. 86.