Investment & Financial Services Association Ltd
ACN 080 744 163

29 September 2006

The Secretary
Parliamentary Joint Committee on
Corporations and Financial Services
Suite SG.64
Parliament House
CANBERRA ACT 2600

Dear Mr Sullivan

RE: Parliamentary Joint Committee (PJC) Inquiry into the structure and operation of the superannuation industry

We refer to the PJC inquiry into the superannuation industry (**the Inquiry**) and make the following submission addressing the terms of reference for the Inquiry.

As a general comment, we consider that a review of the law underpinning the structure and the operation of the superannuation industry is appropriate at this time for a number of reasons. The *Superannuation Industry (Supervision) Act 1993* (**SIS Act**) has not been the subject of any significant review since its enactment and, it is incumbent on the Parliament to ensure that the law and its administration is not out of step with current day requirements and developments, including technological and market developments over the last 12 years.

While we consider that the current structural requirements for the regulation of superannuation are solid, the laws have not kept pace with industry changes and consumer demands. Maintaining the current laws may challenge the efficiency and effectiveness of the superannuation market. The structure for the regulation of superannuation in Australia should enable a viable industry that promotes competition and enables fund investors to save and maximise their retirement savings in a safe and secure environment.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA currently has 135 members who are responsible for investing over $950 billion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes seek to ensure the promotion of industry best practice.

IFSA, as the industry association for the managed investment, superannuation and life industries has as its prime role the advancement of the efficiency and integrity of the financial system and the promotion through government and regulatory channels and public communications the interests of its members.

IFSA members, under our Articles of Association, agree to support the following principles in so far as they apply to the conduct of the financial services industry:

- Competition is an important driver of better outcomes for consumers;
- The industry must be subject to the highest fiduciary standards. IFSA members comply with agreed standards and guidelines.

- Transparency and accuracy in disclosure and market information is a key ingredient of consumer confidence;
- IFSA members should be free to decide on their particular business model, be it a shareholder structure or mutual model;
- IFSA members should be free to decide on how their systems of distribution should operate whether by fee for service, via brokerage or commission; and
- There are important linkages between the manufacturing, distribution and advice and IFSA will engage in activities which enhance and promote the value of these linkages.

The Board of Directors of IFSA is accountable to members for the performance of the company. In carrying out its responsibilities, the board undertakes to serve the interests of its members, its members' customers and the broader community honestly, fairly, diligently and in accordance with applicable laws.

IFSA has previously made comments in submissions to the Government, and to various Parliamentary Committees, on a number of the matters referred to in the Terms of Reference. For the purpose of assisting the Inquiry in its review and consideration of the Terms of Reference, our approach in this submission is to:

- identify the policy principle that IFSA considers should guide the Inquiry's response for each of the Terms of Reference;
- discuss the issues involved;
- make a recommendation.

IFSA is pleased to assist the Inquiry in its review of the structure and operation of superannuation industry.

Yours sincerely

Richard Gilbert
Chief Executive Officer

EXECUTIVE SUMMARY - IFSA RECOMMENDATIONS

1. Whether uniform capital requirements should apply to trustees

1. The law **not** be amended to impose uniform capital requirements on trustees
2. The status quo for public offer superannuation funds be maintained
3. Operational and investment risks be disclosed and explained to fund members.
4. Where operational risk is outsourced it should be to an entity of sufficient substance to carry those risks and support those operational functions.
5. The law should expressly provide that a trustee should not be able to be indemnified from fund assets in respect of a loss incurred by fraud or negligence of the trustee.

2. Whether all trustees should be required to be public companies

The disclosure requirements applicable to a public company should apply to the trustees of all superannuation entities. The law need **not** require the trustee of a superannuation entity to be a public company.

3. The relevance of Australian Prudential Regulation Authority standards.

IFSA recommends that a formal consultative arrangement reporting to the Parliament be established and that legislation be introduced to provide a primary set of responsibilities for each regulator requiring a regulator to rely on regulation by other regulators where they do not have that primary responsibility.

4. The role of advice in superannuation.

That Government should:

- endorse the value of advice particularly in relation to choice of fund and member investment choice;
- reinforce the disclosure basis of our existing laws by facilitating effective disclosure; and
- provide clear guidance to the regulator of the regulatory intent of the law.

5. The meaning of member investment choice; and
6. The responsibility of the trustee in a member investment choice situation.

Sections 52(4), 58 and regulation 4.02 of the *Superannuation Industry (Supervision) Act 1992* should be amended to ensure that the duties of trustees of a superannuation fund offering member investment choice are to:

- **Formulate and document** one or more investment strategy(s) which may be quite broad or very narrow, depending upon the type of fund and number and range of strategies on offer;

- **Manage** those investment strategies in a prudent manner (eg. obtaining appropriate and timely valuations and updating unit price/asset earnings attribution, equitable expense, including tax liability, allocation etc);

- **Acquire, redeem and report** on investments offered and selected by members in accordance with what has been disclosed; and

that responsibility for investment selection within the strategies offered by the trustee is that of the member.

7. The reasons for the growth in self managed superannuation funds

That Government:

1. Notes the primary reasons for the growth of Self Managed Superannuation Funds are control, the perception of poor performance in the retail sector, and the role of financial advisers seeking to address the various savings investment requirements of their clients.

2 Moves to ensure greater investor protection by requiring uniform licensing of providers of financial services to and in respect of Self Managed Superannuation Funds.

8. The demise of defined benefit funds and the use of accumulation funds as the industry standard

That the Committee acknowledge that the demise of defined benefit superannuation funds is the product of an increasingly market driven superannuation environment.

9. Cost of Compliance

All superannuation related legislation, APRA and ASIC regulatory instruments, policy statements, guidance notes and circulars should be subject to industry consultation and cost benefit analysis before implementation.

10. The appropriateness of the funding arrangements for prudential supervision

IFSA recommends that:

1. The industry levy should be based on the risk rating of the entity;

2. The levy should be reflective of the actual costs incurred in supervising entities regardless of asset size; and

3. Measures put in place to monitor and report on the allocation of resources by the regulator to achieve efficient resource management.

11. Whether promotional advertising should be a cost to a fund and, therefore, to its members

1. The law should be amended to list the types of advertising that can be paid for from superannuation fund assets by fund operators.

2. Regulatory responsibility for the regulation of financial services industry advertising

should be transferred from ASIC to the Australian Competition and Consumer Commission (**ACCC**).

12. The meaning of the concepts "not for profit" and "all profits go to members"

That the terms "not for profit" and "all profits go to members" and like expressions should only be used where they are completely accurate or properly qualified.

13. Benchmarking Australia against international practice and experience

1. Government should continue to build an effective and efficient superannuation system in Australia in close consultation with industry.

2. The regulatory costs of the Australian system should be benchmarked against international best practice.

14. Level of compensation in the event of theft, fraud and employer insolvency

IFSA recommends that there should be no expansion of the existing compensation arrangements under the law. If the existing scheme is expanded any failure should be funded by Government.

15 Other matters

15.1 Dispute Resolution Schemes

IFSA recommends that Government reduce, through consolidation, the number of existing external dispute resolution schemes available to consumers.

15.2 Policy Committees

IFSA recommends the removal of the requirement on a public offer fund trustee to take all reasonable steps to establish a policy committee. Regulations could still specify how a policy committee is to operate, if established.

15.3 Unit Pricing

IFSA recommends that:

1. Extant products in the superannuation choice environment be required to implement a uniform unit pricing methodology for the valuation and allocation of investment returns.

2. Closed funds and legacy products using crediting rates should be excluded from this requirement as the requirement would present unreasonable costs.

15.4 Product Rationalisation

That the Government adopt the IFSA legislative proposal for product rationalisation.

15.5 Calculators

IFSA recommends that the relevant provisions of the *Corporations Act 2001* (**Act**) be modified by introducing new regulations under section 926B and section 951C of the Act to exempt providers of calculators, including investment risk and insurance risk profilers which provide personal advice, from the obligations under Parts 7.6 and 7.7 of the Act to

the extent that they apply to a person providing personal advice. The exemption could be subject to conditions set out in the regulations. One such condition could be that the provider complies with industry standards developed in consultation with ASIC.

15.6 Section 1012IA – Custodial arrangements

The Government should amend the operation of section 1012IA of the *Corporations Act 2001* to provide that where as part of a custodial arrangement a client has access to Product Disclosure Statements (**PDS**), arranged by the provider of the custodial arrangement and brought to the attention of the client, the obligation on the provider to give the client a PDS for investments available through a custodial arrangement is satisfied.

IFSA RSPONSE TO THE TERMS OF REFERENCE

1. Whether uniform capital requirements should apply to trustees

Principle 1

Capital requirements primarily address operational risks. All superannuation fund members are entitled to the same basic level of protection, including the security offered by capital. However, in a choice of fund environment the level of risk that a member is willing to take with regard to their chosen fund is a matter for the member. Members, therefore, need clear disclosure on operational risks and capital adequacy.

When considering the role of prudential supervision in a superannuation context the Australian Law Reform Commission and Companies and Securities Advisory Committee (**ALRC**), described prudential supervision as:

> "a series of measures directed at redressing market imperfections in a particular industry. A major way that it does this is by prescribing standards that participants in the industry must observe. It is not a substitute for the assessment of risk by individual investors. Rather, it aims to make it easier for investors to make accurate assessments of the risks involved. For example, by establishing minimum disclosure requirements, a system of prudential supervision can avoid the need for excessive duplication of basic information search costs and provide investors with a proper and reasonable opportunity to measure and assess risk. "[1]

In a superannuation context, the primary risks for fund members are institutional risk, investment risk and operational risks. Capital requirements primarily address institutional and operational risks. Where superannuation funds are not providing a defined benefit, capital is not required to underwrite either investment risk or life risk as benefits are linked to the actual market performance of the fund.

While the *Superannuation Industry (Supervision) Act 199*3 (**SIS**) was developed in a different regulatory environment than operates today, the ALRC statement is equally applicable today as it was in 1992. In particular, fund choice legislation and licensing requirements for regulated superannuation entities (**RSE**) have fundamentally changed the dynamics for the operation of the superannuation system and have created an openly competitive environment across the range of superannuation providers. These factors together with increased fund disclosure and member responsibility for both fund and investment selection provide a regulatory picture that is very different from that established in 1992.

Capital Requirements – section 29DA

SIS introduced universal superannuation in Australia. Up to that time superannuation had been largely restricted to a limited number of employer-sponsored defined benefit schemes and, post the 1986 National Wage Case, industry schemes for employees covered by awards including the entitlement to a 3% wage increase paid in the form of a contribution to a superannuation scheme.

Capital requirements under SIS apply only to public offer superannuation funds. There is, in our view, no justification for universal or uniform capital requirements to be imposed under the law. This does not, and should not, diminish the role of the prudential regulator taking steps to ensure that operational risks are properly managed and that the entities managing them have the

[1] ALRC and Companies and Securities Advisory Committee Report No 59: Collective Investments – Superannuation (31 March 1992)

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financial capacity to ensure performance including against adverse events. This can be done in one or a combination of the following ways.

- The trustee of a superannuation fund operated by a public company will have recourse to shareholders' funds.
- The trustee of a superannuation fund operated under a mutual like structure, such as an industry fund, will have recourse to the members' funds to meet all expenses.
- Some operational risks may be underwritten by external insurers.
- Some risks and operations may be outsourced.

In a competitive choice environment, the prudential regulators interest should not be in imposing 'a one size fits all' capital requirement on superannuation funds, it should be in ensuring that each fund and each entity which insures risk or has risk outsourced to it operational functions, is an entity of sufficient substance to manage those risks and support those operational functions.

In the context of the *Superannuation Safety Amendment Act 2004*, APRA has stated that the capital requirements for the trustees of public offer superannuation entities have a threefold purpose:

- they provide some financial resources to act as a buffer against risk;
- they evidence a commitment on the part of the trustee to its superannuation business;
- they act as an incentive to the trustee to manage the entity well.

In relation to non public offer funds, the lack of capital is a structural differentiating factor. While we consider that a compelling case for uniform capital requirements on trustees has not been made out where operational risk is otherwise addressed, we do recommend that the law should expressly provide that a trustee should not able to be indemnified from fund assets in respect of a loss incurred by fraud or negligence of the trustee.

An approach to address this issue was made in Report 59: Collective Investments - Superannuation and should be reconsidered. That recommendation was:

> **Recommendation 3.1: Indemnification of members of boards**
>
> *1. The law should provide that the responsible entity, and the members of the board of management of the responsible entity, for a superannuation fund, an ADF or a PST may not be indemnified out of the fund, ADF or PST for any liability incurred by it or them while acting as responsible entity or member. Failure to comply should be an offence as well as a breach of fiduciary obligations.*
>
> *2. The law should provide that the responsible entity for a superannuation fund, an ADF or a PST must ensure that the annual report for the scheme include a statement whether the responsible entity or the members of the board of management of the responsible entity are insured in respect of their liability to members of the scheme for loss caused by fraud or negligence and, if they are, the prescribed particulars of that insurance.*
>
> *3. Nothing should prevent the payment out of the fund of the costs associated with obtaining insurance for the responsible entity for the fund, ADF or PST or for a member of the board of management of the responsible entity against fraud or negligence.*

Conclusion

The issue of capital requirements for superannuation entities has been considered by Government on a number of occasions since the enactment of SIS. In our view the Government's response to recommendation 16 of Superannuation Working Group, chaired by Mr Don Mercer, continues to be an appropriate response. Essentially, the response to maintain the status for capital requirements was based on a view at that time that the need for capital in the future may be substantially reduced as other factors come into play to address operational risk. That response was formed part of the package of reforms addressing the safety of superannuation that included licence requirements for superannuation trustees together with enhanced risk management and disclosure requirements.

Recommendation 1

1. The law **not** be amended to impose uniform capital requirements on trustees
2. The status quo for public offer superannuation funds be maintained
3. Operational and investment risks be disclosed and explained to fund members.
4. Where operational risk is outsourced, it should be to an entity of sufficient substance to carry those risks and support those operational functions.
5. The law should expressly provide that a trustee should not able to be indemnified from fund assets in respect of a loss incurred by fraud or negligence of the trustee.

2. Whether all trustees should be required to be public companies

Principle 2

In a choice of fund environment superannuation fund members are entitled to better disclosure in relation to the operations, performance and governance of the trustee and the fund to help them make an informed decision about which fund to choose.

Apart from the family home, superannuation is the most important asset the Australians have. Also. Superannuation contributions are legislatively mandated for employees. Therefore, people should be entitled to a high level of disclosure in relation to the operations, performance and governance of the trustee and the fund that are making decisions about their money. The disclosure rules relating to superannuation entities should provide sufficient transparency so that contributors can make meaningful assessments and comparisons between funds on organisational structure and performance, operational efficiency and governance.

Public companies have a separate set of disclosure requirements under the *Corporations Act 2001*. Given that the majority of employees can now choose which superannuation fund they want to manage their money, as far as is practicable, all trustees should be subject to the same disclosure requirements as public companies. In particular, there is scope for improvement in the related party transaction and disclosure requirements in relation to a superannuation fund. This is increasingly important given that people have more scope to choose their superannuation fund. However, the trustee of a superannuation fund need not be a public company.

Unlike the public company directors who are required to disclose the nature and value of benefits received for services provided, and persons named in a managed investment scheme prospectus who are required to disclose the nature and value of benefits received for services provided to the

responsible entity (related party requirements of Chapter 2 E and the disclosure requirements of section 711(3) of the *Corporations Act*), no such requirements apply in a superannuation context. We would recommend a Trustee Board not currently subject to such disclosure be subject to similar disclosure requirements.

Recommendation 2

The disclosure requirements applicable to a public company should apply to the trustees of all superannuation entities. The law need **not** require the trustee of a superannuation entity to be a public company.

3. The relevance of Australian Prudential Regulation Authority standards.

Principle 3

IFSA is concerned to ensure that prudential standards do not unnecessarily duplicate, overlap and conflict with the roles of other regulators; are not excessively prescriptive, impinging on operational flexibility and the capacity to innovate; do not limit competition, add to costs, restrict the range of choices available to consumers or reduce the price value proposition that they receive.

Part 3 of the SIS Act provides for regulations to be made which prescribe operating standards for regulated superannuation funds, their trustees and RSE licensees while Part 15 prescribes statutory standards for trustees, custodians and investment managers of superannuation entities.

APRA issues Guidance Notes and Circulars which are effectively administered as law but without Parliamentary scrutiny.

This issue highlights the need:

- for meaningful consultation;
- to avoid regulatory overlap and duplication
- for regulation to take into account business costs as well as investor protection.

Meaningful consultation

While APRA may consult stakeholders on the content of its Guidance Notes and interpretative Circulars there is no requirement in the law for it to do so and, even where it does consult, there is no effective mechanism for ensuring that concerns are properly considered. IFSA has outlined its proposals for better regulation in its February 2006 publication - *Towards Better Regulation Policy on Future Regulation of Financial Services in Australia* (**Attachment A**). Those recommendations apply to all industry regulators and seek to address industry concerns with both ASIC and APRA.

To address the regulatory trend for more rules and black letter law there needs to be a shift in regulatory design and more effective consultative processes. IFSA has recommended a three pronged approach that will involve:

1. greater reliance on the development of industry codes of practice and self enforcement;

2. the introduction of a formal consultative process for proposed regulatory changes and reform proposals; and

3. greater emphasis and reliance on the analysis of the costs and benefits of regulatory proposals.

The IFSA recommendation notes that reform proposals can take the form of draft legislation, regulations, legislative instruments and, in some instances, policy papers and guidance notes. It proposes that formal consultative arrangements apply only to matters and issues having a broad impact on industry operations.

The proposal envisages the establishment of a new body referred to as the Financial Services Committee (**FSC**). It may be appropriate for the role of an existing committee to be expanded or evolve to provide the functions envisaged for the FSC, or to simply establish the FSC as a permanent feature of the process of regulatory reform.

The FSC should be a permanent consultative feature of the legislative and regulatory reform process. However, the FSC should only be an advisory body commenting on reform proposals in much the same way as a Parliamentary Scrutiny of Bills Committee, but with member representatives of Financial Services Industry, Government officials and Regulators.

The FSC would effectively have a role in pre-vetting legislative instruments as part of a formal consultation arrangement. It would, of course, still be open to regulators to make legislative instruments without the endorsement of the FSC. However, where such instruments are made without FSC endorsement they would, it is hoped, attract added Parliamentary scrutiny and be subject to possible disallowance.

Given the experience of industry to date to foster meaningful consultation, IFSA does not consider that the Government response to Recommendation 7.20 of the *Rethinking Regulation: Report of the Taskforce on reducing the Regulatory Burdens on Business* goes far enough. While agreeing with the recommendation, that "a standing consultative body comprising senior stakeholder representatives should be established for each regulator whose decision can have significant impacts on business and other sections of the community". This outcome falls short of the IFSA recommendation for a more formal process and an FSC like committee to report to the Parliament on reform proposals.

Regulatory Overlap and Duplication

Investment and financial services companies are regulated by more than one agency. Where different regulators seek to control the same business activities there will inevitably be duplication, overlap and conflicts between requirements.

The Wallis Inquiry recommended *"an allocation of functions among regulatory bodies which minimises, overlaps, duplications and conflicts."*[2] Wallis recommended,[3] and the Government established the Council of Financial Regulators which consists of representatives of each regulator and the Treasury which was charged ensuring that where more than one regulator has an interest in an issue there is collaboration and exchange of information, processes which are facilitated by MOU's between each agency. Unfortunately, it is the industry's experience that these arrangements are ineffective in reducing the regulatory burden on companies and that costly overlaps and conflicts of regulatory requirements remain.

With five regulators (APRA, ASIC, ASX, RBA and ACCC) responsible for various aspects of regulation of the investment and financial services industry the efficiency of both regulation and the industry is dependent on a clear delineation of responsibilities. When each regulator

[2] ibid, page 198
[3] MOU between APRA and ASIC, paragraph 1.2

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develops and pursues their individual objectives without cognisance of the others requirements overlaps, duplication and conflicts are inevitable.

Each regulator may claim that their individual requirements are justified given their unique objectives but the industry is entitled to question whether any additional public benefit that might be derived from a duplicated requirement is not outweighed by the complexity and inefficiency it introduces when the core objectives are already achieved by another regulator's more general requirements.

There is a strong argument for the Government to control the proliferation of regulatory duplication, overlaps and conflicts by legislating to provide a primary set of responsibilities for each regulator and requiring them to rely on regulation by other regulators where they do not have that primary responsibility. A specific case in point is APRA's governance standards which are more prescriptive than the ASX Corporate Governance Council guidelines.

The Regulation Taskforce recommended that:

> *The APRA corporate governance requirements should be consistent with the principles of the Australian Stock Exchange Corporate Governance Council regime which incorporates a similar level of flexibility. There should also be scope to update the requirements to reflect contemporary corporate governance practices."*

The Government addressed this recommendation in its initial response to the Regulation Taskforce in the following manner:

> *The Australian Government notes that APRA is in the process of revising its proposed corporate governance prudential standards following industry consultations in 2005. The Australian Government will refer this recommendation to APRA for consideration prior to finalising its standards.*

APRA subsequently released the final version of its prudential standard on governance. The specific requirements do not have the flexibility of the ASX Corporate Governance Council guidelines, but they do allow companies to seek from APRA an individual variation of the standard.

Recommendation 3

IFSA recommends that a formal consultative arrangement reporting to the Parliament be established and that legislation be introduced to provide a primary set of responsibilities for each regulator requiring a regulator to rely on regulation by other regulators where they do not have that primary responsibility.

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4. The role of advice in superannuation.

Principle 4

Financial advice helps people make informed decisions about how to make the most of their money, as well as investing and protecting it to secure their long-term financial well-being. Financial advice has a particularly important role to play in addressing Australians' underinsurance and superannuation savings gaps, as well as helping to lift financial literacy standards.

This item raises a number of different issues. They are:

- What is financial advice?
- The need for advice.
- The value of personal financial advice
- How consumers pay for advice - remuneration
- Reasonable basis for advice and potential conflicts of interest

What is financial advice?

Professional financial advice assists people to grow and protect their wealth by helping people making informed decisions. Financial advice covers many topics, including household budgeting and saving, managing debt, estate planning, risk protection, social security entitlements, managing tax, investing and retirement savings:

Financial planners provide general and personal advice. Only a licensed financial planner can provide personal advice. Personal advice is tailored to each individual, usually with the development of a long term financial plan. The personal advice process ensures a planner considers the individual's objectives, financial situation or needs, and then recommends strategies and may recommend one or more suitable financial products to help the client reach their financial goals.

The need for advice

Mercer Wealth Solution's 2006 *'Financial Literacy and Retirement Readiness Survey'* reported that:

> "*When working Australians were asked how they would rate (out of ten) their own knowledge about both investments and superannuation, they scored an average of 4 out of 10. This suggests that they readily admit that there is room for improvement. Nearly half rated themselves as having 'none' or only 'minimal' levels of knowledge about investments and superannuation, while less than one in five rated themselves as 'strong' or 'sophisticated'.*

and that the vast majority prefers to consult a financial adviser or account when they need information.[4]

Financial advice and the retirement savings gap

IFSA's analysis of the retirement savings gap in March 2006 estimated that there is savings shortfall of $452 billion, or $93,523 per person in today's terms. The Mercer Survey showed that

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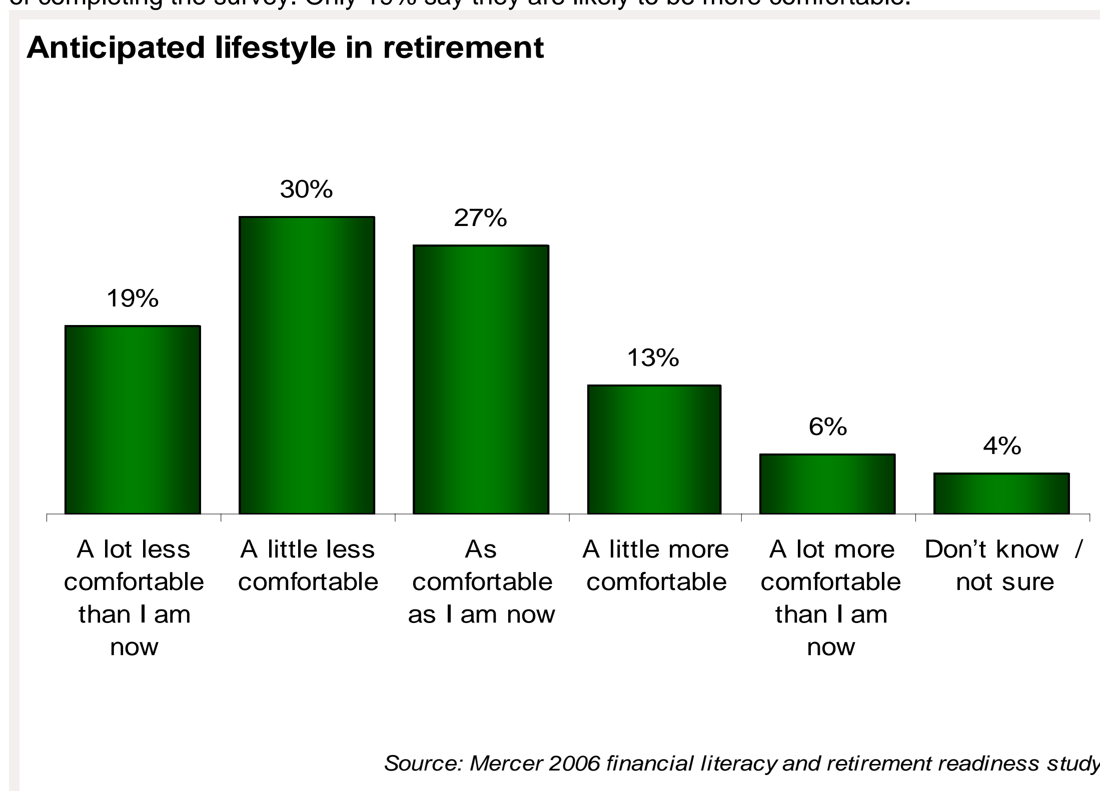
[4] Mercer Wealth Solution's 2006 *'Financial Literacy and Retirement Readiness Survey'* (DATE), Chapter 4 - How confident are Australians in their knowledge about investments and superannuation, at page 15

49% of people anticipate being less financially comfortable in retirement than they are at the time of completing the survey. Only 19% say they are likely to be more comfortable.



Over the last decade, the Government has made significant changes to superannuation that will help encourage people to save more and assist in addressing the savings gap. For example, the generous co-contribution scheme provides a significant incentive for lower income earners to top up their superannuation. Likewise, the recent simplifying superannuation plan will provide a tremendous boost to superannuation savings, by removing the benefits tax and simplifying the rules.

IFSA's retirement savings gap research demonstrated the importance of encouraging Australian's to make additional superannuation contributions above the basic Superannuation Guarantee. Results from the research find that for example, a 38 year old female with average income would need to make additional contributions of 9.3% above the basic Super Guarantee to close the savings gap and achieve adequate income in retirement.

However, it is not clear that people are taking advantage of the incentives to voluntarily contribute to superannuation. Research conducted by Newspoll for IFSA in July 2006 showed that only 23% of people are currently making additional contributions to their superannuation (see **Attachment B**). Table 1 shows that the highest proportion of those making additional contribution are those closest to retirement.

Table 1: Additional contributions to superannuation by various groupings.

	Additional contributions into Superannuation
Total	23%
18-34	10%
34-49	30%

50-64	33%
Married	29%
Not Married	14%
Less than $70,000	21%
$70,000 plus	27%
Have a financial adviser	39%
Do not have a financial adviser	17%

The Australian superannuation system places a lot of responsibility on the individual to make financial decisions. For example, the individual is responsible for determining how much income they want in retirement and how much they need to save in order to achieve it. Likewise, the individual is responsible for determining the way in which their superannuation is invested based on their attitude to investment volatility.

Knowing which decisions to make and how to take advantage of the different incentives in order to maximize superannuation savings can be a complex and difficult decision for many people to make. Undoubtedly education, information and quality advice are critical in helping people understand how take advantage of the many incentives and achieve their retirement goals.

Financial planners and the role of advice is an important factor in helping people understand how to make the most of their financial situation. For example, the results from Table 1 (above) show that those seeing a financial planner are twice as likely to make additional contribution to their superannuation compared to those that do not see a financial planner.

The Government's Financial Literacy Foundation initiative and the launch of its *'Understanding Money'* campaign is an important step in raising financial literacy standards within the community, helping prepare people to make important financial decisions. While these programs serve to highlight the importance of financial matters and will help to ensure that future generations are better prepared to manage their financial affairs, the importance and value of professional financial advice in delivering behavioral outcomes today cannot be understated.

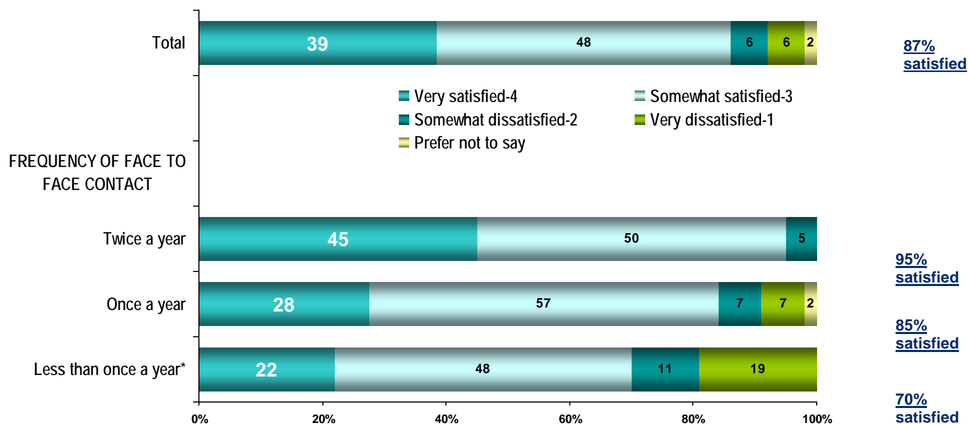
In recent years, there has been much criticism of financial planners and the value of the advice they provide. While there have been some issues in meeting the requirements of the financial services regime (introduced in 2002 and effective from 2004), the criticism directed at the advice industry has a significant impact on peoples' impression of the advice industry and ultimately reduces individuals confidence in seeking advice from professional financial planners. Many individuals would benefit significantly from receiving financial advice as opposed to doing nothing.

<u>The value of personal financial advice</u>

A study undertaken by Taverner Research for IFSA in December 2005 revealed that 87% of individuals that use a financial planner (40% of those with Super) are satisfied with the level of service they receive (Chart 1 below). For those who interact with their financial planner at least twice a year, the proportion increases to 95%.

Satisfaction with Financial Adviser

Taverner Research December 2005
Base: Currently use a financial adviser - n=147



***Small base, treat percentages with caution**

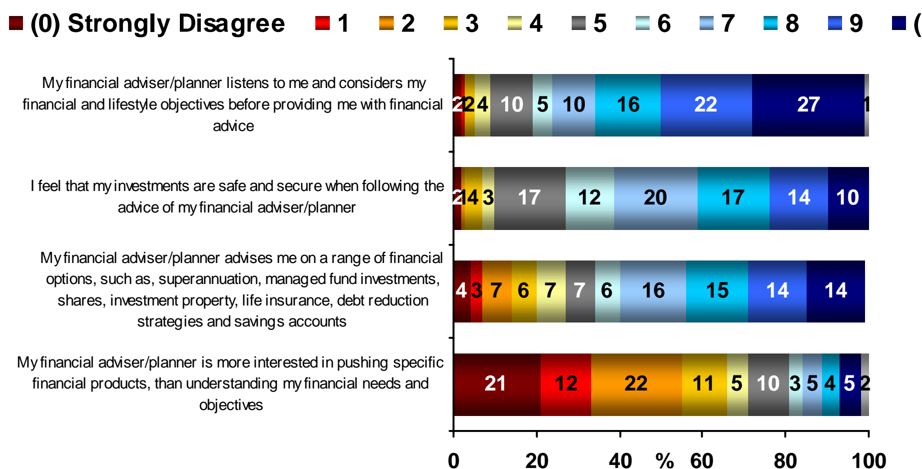
Q21A. ***How satisfied would you say you've been with your personal experience with financial advisers/planners? Would you say…***

Importantly the advice they receive extends beyond just superannuation, with 73% of respondents agreeing with the statement

> *'My financial adviser/planner advises me on a range of financial options, such as, superannuation, managed fund investments, shares, investment property, life insurance, debt reduction strategies and savings accounts'*

The responses to this statement are shown in Chart 2.

Chart 2:



International research also supports the value of advice in boosting retirement saving. A 2002 report from the Association of British Insurers shows that 46% of low to middle income earners

said that they would not have commenced retirement saving without receiving advice from a planner to do so.

IFSA believes that the industry and its stakeholders, including government and regulators, should actively promote the importance of financial advice, particularly for superannuation. Certainly, the role of financial advice needs to be acknowledged as an important and desireable component in both the choice of fund and member investment choice scenarios.

How consumers pay for advice - remuneration

There are a number of ways that consumers can pay for their financial advice – as a commission, an agreed percentage of their assets, or a fee for service, or a combination of these ways. It is important to ensure that consumers are able to choose how to pay for financial advice and a range of available payment options.

Commissions have received negative coverage in the media, by consumer groups and the regulator. The suggestion is that commissions create conflicts of interest and that financial planners only recommend products that pay the highest commission. This has translated into the approach of ASIC to conflicts of interest, strongly suggesting that industry should reduce its reliance on commissions and move to a fee for service remuneration model.

However, the facts are that financial advice, like any professional service can be expensive with an initial financial plan costing on average between $2,500 and $3,000. Paying the full cost of financial advice upfront as a fee for service payment is out of the reach of many Australians seeking financial advice. It also creates a barrier to those not financially well off in seeking advice. Commissions allow people to access advice and pay for it over time via their savings. Commissions also tie the interest of the consumer and the financial planner, and give an incentive for the planner to maximise a consumer's savings.

Removing commissions from the remuneration mix will be to the detriment of middle to lower income consumers who cannot afford to pay the fee for service. IFSA believes that commissions are an important means of paying for advice, and any perceived conflicts of interest can be managed by disclosure.

ASIC should ensure that it does not limit the remuneration methods available to both consumers and advisers. It is not for ASIC to determine whether commission or fee-for-service arrangements are the most appropriate form or remuneration. Indeed the current disclosure requirements in the law and the significant investment by both Government and industry in raising the standards and enhancing the regulation of financial advisers should not be undermined by the regulator. Instead, in a highly competitive and transparent market (driven by FSRA disclosure provisions on fees), competition should be the effective regulator on remuneration structures and payment levels.

The Government response to Recommendation 12 of the Report of the Senate Select Committee on Superannuation Report: Planning for Retirement was, in our view, appropriate. That recommendation and response were:

> ***Recommendation 12***
> *The Committee recommends that the Productivity Commission investigate the remuneration arrangements for financial planners, especially whether there should be a more direct relationship between the amount of work performed and the fee charged.*
>
> ***Response***
> *The Government considers that it should not directly intervene in remuneration arrangements for financial service providers and superannuation investment fund*

managers. The Government believes that it is for the market to determine the level of fees, costs and remuneration applying to financial services provided by advisers.

The Government is committed to ensuring a robust, competitive market for financial services and products, including those for superannuation, through the mechanism of disclosure. Financial services regulation under Chapter 7 of the ***Corporations Act*** *2001 requires full disclosure of fees charged by advisers and remuneration they receiver from product providers, including commissions in various forms. This is achieved through upfront disclosure before advice is provided in a Financial Services Guide and as part of the Statement of Advice when personal financial advice is given. Disclosure requirements include revealing a non-monetary benefit or interest, for example, 'soft dollar' commissions.*

The Government believes that it is important to avoid regulating the market in such a way that distortions are created whereby only fee for service financial advice is provided. Such an outcome might have the undesirable outcome that access to financial advisers is denied to those unable to afford fees for service.

Consumers should have the choice in how they want to pay for financial advice, be that by a commission or on a fee for service basis.

Industry structures and conflicts of interest

The financial services market is characterised by a significant degree of horizontal and vertical business integration in addition to boutique operations. The diversity within our industry is a significant strength and offers investors a wide range of investment choices.

Reasonable basis for advice, the approved product and services lists

In giving advice, planners are required to ensure there is a reasonable basis for the financial strategy(s) they suggest and any product recommendation they make. Based on the current views of the regulator, there is concern within the industry about how planners are able to meet this obligation when recommending products from a restricted approved products and services list (**APSL**). The use of an APSL also raises issues about how the licensee can effectively manage conflicts of interest, particularly where in-house and related party products are on the list.

The regulator has raised concerns about the use of an APSL and meeting the reasonable basis for advice requirement. Under section 945A of the Corporations Act, a financial planner must give consideration to, and conduct an investigation into any product when making a product recommendation to a client and, must ensure the product is appropriate to their client's circumstances and needs.

The regulator has raised the question as to whether the APSL may prevent a planner meeting the reasonable basis of advice obligations, particularly when switching advice is given. IFSA believes that the law requires a planner to ensure that any product recommendation that is made must be *appropriate* for the client. The planner is not required to recommend the *best* product in the market. Therefore, as long as the products on the planner's APSL contains products that are appropriate to meet their client's needs (regardless whether they are in-house products), then a restricted APSL should not prevent a planner meeting their reasonable basis obligations. The law requires planners to recommend appropriate, not best products.

Conflicts of interest

The financial services market is characterised by a significant degree of horizontal and vertical business integration in addition to boutique operations. The diversity within our industry is a significant strength and offers investors a wide range of investment choices.

The Discussion Paper released by ASIC in April 2006 entitled **MANAGING CONFLICTS OF INTEREST IN THE FINANCIAL SERVICES SECTOR** gave rise to a significant level of concern amongst industry participants. Taken to its extreme, the ASIC approach to conflicts management would have had the effect of undermining existing industry structures and operations and limiting the range of choice and services to consumers.

The *Corporations Act 2001* addresses potential conflicts of interest in a systematic way, principally through disclosure and the requirement for conflicts management. Section 912A(1)(aa) of the Act requires a financial services licensee to 'manage' any conflict arising for its financial services business. The section does not require a licensee to avoid conflicts unless, of course, the conflict would breach another provision of the law. That obligation reflects the commercial reality that business arrangements and behaviour must comply with the law.

"A critical lesson from the common law is that conflicts of duty and interest as such are not objectionable per se. What is objectionable first and foremost, are undisclosed conflicts"[5].

The ASIC Discussion Paper appeared to express a bias particularly against conglomerate arrangements and institutional ownership of advisor groups. The fact is that many customers prefer to obtain advice from an adviser who is backed by the financial strength and security of a large financial institution and to invest through a product from the parent institution as long as it is clearly disclosed and they receive choice and appropriate advice regarding their underlying investment and insurance options.

IFSA responded to ASIC in a positive way acknowledging the role of ASIC in providing guidance but recommending that the case study approach adopted in the Discussion Paper be replaced by a principles based approach (IFSA Submission dated 23 June 2006). Industry concern with the use of limited fact case studies is that they can ultimately be used by field officers as a substitute for the law and this can cause considerable dislocation to a fair and efficient regulatory system. Rather than offering guidance, the use of case studies can potentially create uncertainty. IFSA offered to work more closely with ASIC on developing Principles which appeared in draft form in Section D of the Discussion Paper.

Of particular concern in the advice context was the ASIC commentary on its CASE STUDY B11 - Super funds that don't pay commissions. It states that:

> *"the remuneration model forces AdviceNetwork to prefer commission paying products over products that do not pay commissions. Ideally, this conflict* ***should be avoided*** *and is only partly addressed by disclosure and control mechanisms".*

Generalised, the comment is not consistent with both legal requirements and Government policy, nor does it reflect client payment or selection preferences. It should be recognised that, in the process of making a purchase decision, customers are influenced by a range of factors such as brand, reputation, utility, efficiency, reliability, risk as well as current and past relationships. The fact that a providing entity's fees are based on commission means that while there is a potential conflict of interest that must be appropriately disclosed, it doesn't necessarily mean that the client is disadvantaged. In fact, the very opposite may be true once the full range of client choice factors are taken into account.

The example provided suggested that the licensee does not permit its advisers to charge fees for service. IFSA is not aware of any licensees within its membership that do not provide advisers the choice to operate on a fee for service basis where the client pays directly for the advice. In all likelihood, the example is not relevant because it does not reflect current industry practice.

[5] Finn, 1993, page 97 ….taken from St James Ethics Centre website www.ethics.org.au

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However, if this were to be the case, the adviser could elect to change licensee and/or, the client could choose an adviser that could provide such a facility. To our knowledge, under the current law these two options operate in a highly contestable market (ie. no fetters on member choice and competitive adviser market). Advisers and clients have the right to determine what is in their own interest and to make the choice accordingly. Many clients prefer to pay their adviser through a commission or through a fee for service negotiated with their adviser. For adviser and client convenience the payment is often collected through the product platform.

If some superannuation funds choose not to provide this choice to their clients, or to restrict the arrangement to a limited number of advisers, then that is a matter for a highly contested market to determine. In many cases, funds that do not provide this choice also do not provide the opportunity for members to benefit from financial advice and accordingly do not offer a mechanism to allow clients to pay for advice. Some funds do provide access to advice through salaried advisers paid by a related entity. In some instances, not all of the costs of advice are borne by the client through the fee for service. The fee for service payment, or part thereof, is indirectly drawn from the client account in the relevant fund thereby lowering the overall returns to the client through that fund. Other funds might provide the advice via a subsidy from the whole of the fund. All of these various arrangements involve possible conflicts of interest and should be clearly disclosed.

Recommendation 4

The Government should:

- endorse the value of advice particularly in relation to choice of fund and member investment choice;
- reinforce the disclosure basis of our existing laws by facilitating effective disclosure; and
- provide clear guidance to the regulator of the regulatory intent of the law.

5. The meaning of member investment choice; and

6. The responsibility of the trustee in a member investment choice situation.

<u>Items 5 and 6 are interdependent.</u>

Principles 5 and 6

1. Advice is fundamentally important in a member investment choice environment.
2. A trustee is generally not in a position to second guess the investment choice of a member.
3. The role of a trustee in a member investment choice regime is to ensure that the investments available for selection by the member are suitable for incorporation into a member's investment savings strategy.
4. Superannuation is now personal investment and investment choice is the member's responsibility.

Following the enactment of SIS, the financial services industry developed structures to deliver investment choice to fund members in accordance with sections 52(4), 58 and regulation 4.02 of the SIS regime. Member investment choice is, therefore, not a new concept. When combined with rapid technological advances and greater administrative efficiencies in the 1990s, member investment choice became part of the framework for the development and rapid growth of superannuation administration platforms that are offered mainly through licensed investment advisers.

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APRA regulation of Investment Choice

APRA Superannuation Circular II.D.1 "Managing Investments and Investment Choice" (**Circular**) was originally issued by APRA in 1998 and was updated and reissued in March 2006. The 2006 Circular was issued following extensive and constructive consultation between APRA and IFSA. We believe that while the changes made in the Circular following IFSA's representations improved the document, there remains a fundamental uncertainty in the law which gives rise to a difference in interpretation by IFSA members and APRA as to the operation of sections 52(4) and 52(2)(f) of SIS.

It is the view of IFSA that the position now adopted by APRA on member investment choice is inconsistent with the original intent of the law. APRA's views, as set out in the Circular, are a departure from the superannuation industry's interpretation of the relevant SIS provisions and the way in which APRA has allowed the master fund/WRAP industry to develop over the last decade. The APRA approach would place significantly more responsibility on a fund trustee in a member investment choice situation over and above responsibility for offering and managing suitable investment strategies for members.

This issue is of increasing significance as the platform industry continues to grow rapidly. If the current situation is not corrected, and limitations are placed on investment choices made by members within certain investment categories, regulated superannuation funds will be at a competitive disadvantage to self managed superannuation funds (**SMSFs**) where there are no investment choice restrictions. As a result, superannuation investment choice, some clients will transfer to a SMSF to create the flexibility they need to avoid what they and their advisers will perceive to be limited investment choice within a fund and vanilla investment outcomes. Given the uncertainty in the interpretation of the relevant provisions, IFSA considers that this matter should be determined by the Government and the law amended to clarify the operation of sections 52(4) and 52(2)(f) of the SIS Act.

Investment Choice, investment caps and the role of advice

APRA has advised that under SIS, the availability of advice to fund members is not a relevant consideration that trustees can take into account in satisfying their responsibilities to fund members. Yet in the investment choice context, administration platforms provide the 'infrastructure' (reporting, trade execution, custody etc) for advisers/dealer groups to implement and run investment strategies of their clients. Likewise, trustees offering member investment choice are under a legal obligation to formulate and document one or more investment strategies on offer to members. In so doing, and based on differing legal advice, some trustees have placed investment limits on certain asset types.

Some IFSA members offering superannuation administration platforms have experienced significant negative comment from advisers and dealer groups regarding investment limits in Superannuation (for managed funds and equities) where the trustee requires them. There is a strong consensus across the adviser community that platform providers are not in a position to know what is / is not a good investment for their individual clients and it is unreasonable and unrealistic to expect trustees to do so.

Advisers/dealer groups have statutory responsibilities to know their clients financial position and goals and are able to utilize the investment platform as an efficient 'execution / maintenance tool'. To address their statutory obligations for the provision of advice to retail clients, advisers/dealer groups generally establish investment committees for the purpose of conducting due diligence on funds and stocks (this also involves looking a rating agencies) as part of an investment strategy.

Model portfolios developed by dealer groups are designed to provide investors with a structured portfolio and exposure to certain asset types.

The facts are that a client may hold a significant part of their overall portfolio outside of a platform. Under the investment choice model permitted by the law, portfolio construction is the responsibility of the member and investment selection will generally be holistically based on the allocation of investments across the asset classes of cash, fixed interest, shares and property according to the client's risk tolerance and investment time frame. These are matters that the platform provider will not know.

IFSA considers that the regulatory arrangements introduced by Government for investment choice, in both superannuation and non-superannuation products, are primarily disclosure based. Based on our understanding of the law, the **prudential obligations** of a trustee in a superannuation investment choice and fund choice scenario, are to have in place appropriate systems to:

- **Formulate and document** one or more investment strategy(s) which may be quite broad or very narrow, depending upon the type of fund and number and range of strategies on offer;
- **Manage** those investment strategies in a prudent manner (eg. obtaining appropriate and timely valuations and updating unit price/asset earnings attribution, equitable expense, including tax liability, allocation etc);
- **Acquire, redeem and report** on investments offered and selected by members in accordance with what has been disclosed.

The availability of investment choice recognises that no single strategy is best or appropriate for each and every member, particularly for members of large and widely offered funds. This implies that the strategies that may lawfully be offered by trustees will involve varying levels of risk, including risks associated with reduced levels of diversification (as compared to other strategies).

While there is much in the APRA Circular with which industry would agree, the critical differences revolve around an interpretation of the law that would effectively extend trustee responsibility to individual member investment choice and ignore the availability of financial advice in member investment choice. SIS should be amended to expressly recognise the role of advice in superannuation and to limit the role of a trustee where member investment choice is offered to the formulation and documentation of investment strategies, managing investments selected by members, and to acquiring redeeming and reporting to members on those investments.

Recommendations 5 and 6

Sections 52(4), 58 and regulation 4.02 of the *Superannuation Industry (Supervision) Act 1992* should be amended to ensure that the duties of trustees of a superannuation fund offering member investment choice are to:

- **Formulate and document** one or more investment strategy(s) which may be quite broad or very narrow, depending upon the type of fund and number and range of strategies on offer;
- **Manage** those investment strategies in a prudent manner (eg. obtaining appropriate and timely valuations and updating unit price/asset earnings attribution, equitable expense, including tax liability, allocation etc);
- **Acquire, redeem and report** on investments offered and selected by members in accordance with what has been disclosed; and

that responsibility for investment selection within the strategies offered by the trustee is that of the member.

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7. The reasons for the growth in self managed superannuation funds.

Principle 7

Individual consumers have the right to determine what is in their best interests and how their retirement savings should be invested.

Self managed superannuation funds (**SMSFs**) have become an increasingly significant part of the Australian superannuation landscape over the last five years. The Reserve Bank of Australia in its Financial Stability Review report stated:

> By fund type, industry and self-managed funds have recorded the strongest growth in assets under management over recent years. These funds, together, account for nearly 40 per cent of industry assets, compared to around 23 per cent five years ago (Graph 59). At the same time, there has been a decline in the share of total superannuation assets held in public sector and corporate funds[6].

IFSA commissioned Investment Trends Pty Limited (ABN: 141 074 856 56), a specialist research and consulting organisation, to produce a report examining the SMSF market, drivers of growth to date, asset allocation, the role of advisers and the role of managed funds within SMSFs. The report is based on two detailed quantitative surveys totalling 1,189 SMSF members conducted by Investment Trends in December 2004 and October 2005. A copy of the February 2006 report, *SMSF Trends*, is attached (**Attachment C**).

As advised in the Report, SMSFs are now the second largest segment of the superannuation market behind retail super. As of June 2005, around 300,000 SMSFs held $166 billion in super assets, up 24% in the preceding 12 months (Source: APRA). Assets held in SMSFs are now growing faster in percentage terms than any other superannuation category besides industry funds.

The research found that SMSF investors cite an average of 3.3 main reasons each for setting up their SMSF. While there has been a belief that SMSF growth was cost driven, only 24% of the SMSF investors surveyed cited saving money on fees as an important driver. Four distinct, though overlapping, reasons for establishing an SMSF were identified. They are:

- **Control** - By far the most popular reason given for setting up a self managed super fund is investors' desire to exercise more control over their super (55%).
- **Poor performance** (36%) from existing super funds often drawing attention to fund charges (20%)
- **Accountant's suggestion** (33%)
- **Financial planner suggestion** (29%)

The researchers noted the proportion of investors reporting that both financial planners and accountants as the instigators for the establishment of SMSFs had fallen over recent years, as more investors themselves initiate the establishment of an SMSF. However, it must be recognised that recommendations from accountants was a catalyst in the significant growth of SMSFs over the past decade and continues to be a significant driver.

It should be noted that the element of control is available and used by many SMSFs through administrative platforms (retail WRAP arrangements) offered by the funds management industry. While a certain level of control is also available to investors through retail superannuation master funds, the regulatory approach of APRA has been to limit member control and investment choice.

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6 Reserve Bank of Australia, Financial Stability Review , September 2006 at page 37.

The Butler Walker 'Analysis' (July 2006) publication makes the following comment on the small fund market:

> The small fund market is an enigma. Operating costs are high and there is little evidence of better performance. Yet, many Australians take this option. People want greater control; distrust institutions; think they can do better etc.

Certainly, moves by APRA to restrict member investment choice are a relevant factor in the expansion of this market segment.

The Provision of Appropriate Licensed Advice

As can bee seen above, accountants play a major role in the establishment of SMSFs with 33% of investors who participated in the research saying that they established a SMSF at the suggestion of an accountant. An area of ongoing concern is that of the role of the accountant, particularly where they are acting outside the Corporations Act licensing regime.

Examples of potential consumer detriment in the SMSF area are evidenced in both the recent ASIC Shadow Shopping Survey on Superannuation Advice and the following from ASIC's Chairman at a recent conference when commenting on ASIC's "work on illegal early access to superannuation", Mr Lucy said;

> "ASIC is working closely at a cross-agency level with APRA and the ATO to minimise transfers from legitimate superannuation funds to sham self-managed superannuation funds[7]"

The Shadow Shopping report ,released by ASIC, covered twenty two cases of advisers who were not licensed to provide advice. Eighteen of these were accountants[8]. The report stated;

> "In some limited circumstances, accountants can give advice on superannuation issues without needing to come within the AFS licensing regime." It went on to say "In four cases the unlicensed accountant stayed within the accountant's exemption". Further "in 16 other cases, 14 unlicensed accountants and two tax agents illegally gave advice on issues that required a licence. These cases included:
>
> - advising the client about particular superannuation funds (not SMSFs), including staying with an existing fund, consolidation and asset allocation decisions within funds; and
> - recommending making extra contributions to a specific super fund to access tax benefits, without warning that other factors may be relevant and the client should seek advice from a licensed adviser."

The examples expose a significant risk to some superannuation investors and, although the sample was small, it showed that almost 78% of the accountants covered in this survey gave consumers illegal advice regarding superannuation.

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[7] ASIC's Super Strategies: 2006–07 An Address by Jeffrey Lucy AM, Chairman - Australian Securities and Investments Commission at The Association of Superannuation Funds of Australia 6 September 2006 Sydney, Australia

[8] Shadow shopping survey on superannuation advice - An ASIC report April 2006

The industry has long argued for a level playing field in relation to the regulated provision of financial services and, in particular, the removal of the special treatment of accountants when providing services in relation to SMSFs.

The initial regulation which became effective in May 2003[9] provided, in our view , sufficient scope for the accounting profession to deal with appropriate matters required for the efficient administration of a fund. The extension of that scope by a further regulation which became effective in February 2004[10] has led to confusion within the accounting profession as to where the line is drawn and in some cases, as shown in the ASIC report, an inappropriate outcome for investors. It is our recommendation that at the very least this latter Regulation should be removed for the avoidance of doubt and to ensure consumers are protected by the appropriate licensing regime.

Recommendation 7

That Government:

1. notes the primary reasons for the growth of Self Managed Superannuation Funds are control, the perception of poor performance in the retail sector, and the role of financial advisers seeking to address the various savings investment requirements of their clients.

2. moves to ensure greater investor protection by requiring uniform licensing of providers of financial services to and in respect of Self Managed Superannuation Funds.

8. The demise of defined benefit funds and the use of accumulation funds as the industry standard fund.

Principle 8

The introduction of compulsory retirement savings, and an increasing propensity on the part of employers to shed responsibility for superannuation as not being core to their business, together with greater labour market flexibility, have caused a shift from defined benefit schemes which typically gave a narrow cross-section of employees significant benefits to a more general and equitable distribution of employer provided benefits through market linked products.

Prior to the introduction of compulsory superannuation saving through the Superannuation Guarantee most superannuation was provided to a limited range of government and corporate employees through employer sponsored defined benefit funds. These schemes, while in many cases quite generous, tended only to provide significant benefits to very long term employees.

One of the outcomes of a more open economy, structural reform and increased labour market flexibility during the mid to late 1980's and early 1990's was changes to occupational superannuation with the introduction of award superannuation and then the superannuation guarantee levy. This was followed by the closing to new members of defined benefit schemes not only by employer sponsors but also by government, including the military and more recently parliamentary schemes. New members are offered participation in an accumulation scheme (defined contribution schemes). The remaining defined benefit scheme arrangements tend to be for services, fire and police etc, where the physical nature of employment requires early retirement.

[9] Regulation 7.1.29(5)
[10] Regulation 7.1.29A

Reasons for this both in Australia and globally have been:

- Increased costs in providing defined benefit retirement pension plans;
- Avoiding the risk of under funding and shifting of risk for investment performance from the employer to the employee;
- Increased individual involvement, more investment choice, immediate vesting, and portability at job change

Increased costs
Population ageing has seen not only an increase in the number of people who survive to retirement, but also larger numbers of people living for much longer periods in retirement. This trend has increased costs of providing defined benefit retirement pension plans and raised significant doubts about the affordability of defined benefit pensions into the future. As a result, many defined benefit plans in the developed world are either closed to new members or have been terminated altogether.

Increased risk
Employers find defined contribution plans attractive because they are easy to communicate to employees and there is no under funding risk. The shift from defined-benefit to defined-contribution pension plans effectively transfers risks from employers/governments to individuals. Such risks include market risk, inflation, investment planning, and longevity risk.

One of the principal objectives of the federal government when it closed the various defined benefit schemes was to provide arrangements which would give all members, no matter how long or short their tenure as a government employee, a fairer allocation of benefits provided by the employer. The shift to accumulation schemes also constrained the emerging funding gap for governments and has limited the prudential risk associated with corporate schemes.

The trend away from defined benefit scheme arrangements is consistent with greater labour market flexibility with employees now more likely to have a larger number of different employments during their working lives, addressing the potential for unfunded liabilities by having market linked accumulation schemes, and placing greater responsibility on individuals for the growth of their retirement savings.

Greater member involvement and choice
Defined contribution plans have become attractive to employees because of increased individual involvement, more investment choice, immediate vesting, and portability at job change.

In Australia, the shift to a defined contribution model is relatively advanced. The Australian Government has implemented a number of measures aimed at reducing growth in unfunded public sector superannuation liabilities, including the establishment of a Future Fund. The Future Fund will begin to fund the superannuation liabilities already incurred but for which no provision has been made. The Fund aims to accumulate financial assets to offset the Government's liabilities by 2020.

Recommendation 8

That the Committee acknowledge that the demise of defined benefit superannuation funds is the product of an increasingly market driven superannuation environment.

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9. Cost of compliance.

Principle 9

APRA should be required to consider, and take into account, industry efficiency and the cost of compliance in its administration of the law.

The costs of regulation include not only regulatory levies and cost incurred for internal and external compliance and administration resources, but also costs associated with limiting the choice of products and processes and inhibiting innovation. Superannuation regulatory costs are incurred both as a consequence of complying with the law and requirements imposed by ASIC and APRA.

Legal compliance is a significant operational undertaking for financial institutions generally. The volume and scope of regulation has the potential to create a compliance driven culture that may lead to a risk adverse business environment. Additionally, the apparent perception of government officials and regulators that industry has the resources and can implement changes "overnight" at minimal cost is a serious concern.

The cost of regulation indirectly affects customers. While product and service providers have and will continue to absorb some costs, the reality is that a significant portion of regulatory costs incurred are passed onto customers. Unnecessary costs erode future savings.

The Financial System Inquiry[11] considered that Australia's regulatory costs in 1997 were high, with only the US having higher compliance costs. The report estimated total compliance costs in Australia as exceeding $720 million, equivalent to 7.6 basis points of assets. Since 1997 there have been a series of major legislative reforms commencing with the *Managed Investments Act 1998* through to the *Financial Services Reform Act 2001*[12] and finishing with the Superannuation Safety[13], Superannuation Choice[14] and CLERP 9 Acts[15]. Each had a major impact on industry structures and involved a significant additional compliance element. The Anti-Money Laundering and Counter Terrorism reforms are about to impact the industry.

The IFSA Key Industry Statistics Survey for the last 5 years has shown that there have been significant increases in the costs to industry in the areas of information technology, regulatory compliance and customer service. The current costs for IFSA member companies to comply with the financial services industry regulation is about 10 to 15% of total operational costs.

Given that even minor regulatory changes will now generally involve some changes to the technology and operational systems underpinning the delivery of products and services, the compliance costs of relatively small regulatory changes may be quite high. The Government response to the *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* is moving in the right direction to address the implementation of reforms that have not been subject to adequate consultation and cost benefit analyses. However, in this context we repeat our recommendation at item 3 above for the introduction of a formal consultative arrangement to report to Parliament.

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[11] The Treasurer announced on 30 May 1996 the establishment of an Inquiry into the Australian financial system, to report to him by 31 March 1997

[12] The Financial Services Education Agency Australia (FSEAA) reported by Media Release dated 13 December 2005 that just to get compliant under FSR has cost Australia's licensed Financial Services providers more than $224 million. The survey was undertaken by Victoria University, funded by the Taxpayers Research Foundation Ltd and supported by FSEAA

[13] Superannuation Legislation Amendment (Superannuation Safety and Other Measures) Act 2005

[14] Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004

[15] Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004

Costs of providing superannuation

The following provides a short statement of the drivers for the cost elements in operating a superannuation business in compliance with all legal requirements.

1. Staffing and Recruitment

Staff with appropriate expertise is becoming increasingly difficult and expensive for regulated entities to source as the regulatory regime has become more complex. Employment costs are a significant proportion of total compliance costs for regulated entities.

Increasing regulatory complexity leads to the need to have access to legal, compliance and risk expertise. Market forces have meant that those with the appropriate expertise have been able to command higher salaries, which has lead to increased compliance costs for regulated entities. A review of the large number of financial services legal, compliance, and risk roles advertised by recruitment firms at any point in time and the salaries which they can command, provides an indication of the high demand for and cost of individuals with relevant expertise.

2. RSE Licensing Specific Issues

The framework for RSE licensing is sound, however, unless there is good reason for differentiation, the responsible entity and managed investment regimes should be the same. A single set of licence requirements should apply to entities that are both responsible entities of managed investment schemes and trustees of regulated superannuation entities. We note that following inconsistencies between these regimes with lead to increased compliance costs for RSE:

Breach Reporting

Industry has raised this issue in a number of submissions to Government. Whilst we note that Government has made a commitment to review this matter as part of the FSR Refinements process, this is a good example of where regulatory inconsistency has increased costs to RSE's at the expense of other risk mitigation measure.

The requirement to report all breaches, whether or not material has lead to an excessive cost burden through the development and ongoing management of incident management systems. As a result there is a concern that limited resources are committed to "incident management" rather than focussing on underlying root causes.

Responsible Officers

The requirements applying to the appointment and continuing performance of responsible officers should be the same under Corporations Act and SIS.

Compliance Plans/Risk Management Plans

Content, audit, review and lodgement requirements applying to compliance plans under the Corporations Act and to Risk Management Plans under SIS should be aligned.

3. Regulatory Costs

Regulation adds to costs. The superannuation industry carries significant compliance costs and the regulator has significant costs which are passed on to regulated entities through levies.

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These costs are ultimately borne by shareholders and consumers both as expenses against investment returns and reductions in the value proposition of regulated products.

Recommendation 9

All superannuation related legislation, APRA & ASIC regulatory instruments, policy statements, guidance notes and circulars should be subject to industry consultation and cost benefit analysis before implementation.

10. The appropriateness of the funding arrangements for prudential regulation

Principle 10

An appropriately funded regulator is an important element of a well regulated industry. However, such regulation also requires regulators to efficiently allocate resources.

We note, with some concern, the significant increase in the levies for larger entities, particularly superannuation entities. It is questionable whether the justifications put forward for the increase in the levy to be collected from industry are sound. We particularly note that the superannuation trustee population, post the conclusion of the superannuation licensing transition period on 30 June 2006, will be less than one third of that prior to the commencement of the transition period. We understand that as at 11 May 2006, only 248 licences had been issued of the 325 trustees that had sought an RSE licence and, that the trustees of 876 superannuation entities had not applied for a licence.

IFSA acknowledges two key concerns in relation to the regulation by ASIC and APRA. They are:

- both our regulators have a need to recruit and retain quality human resources, and to this end industry has a responsibility to assist wherever possible; and
- our regulators have had a clear and discernible need for increased funding to address the implementation and ongoing regulation resulting from the significant changes under Financial Services Reform Act (**FSRA**), the introduction of Super fund choice and Super Safety post HIH (although HIH had somewhat limited implications for the regulation of superannuation funds).

Following the implementation of these major legislative changes, it is now appropriate that our regulators examine their resourcing in light of a more settled regulatory environment and market conditions. It is IFSA's view that, as with any business entity, there are always opportunities to make efficiency gains to lower overall cost structures. Part of any such review involves the need prioritise the use of limited resources to areas identified as presenting the greatest risk and warranting the most regulatory attention. Pricing of regulatory services should then reflect the risk and regulatory allocations of resources - the higher the risk the higher the regulatory levies for that segment of business.

IFSA looks forward to working with both APRA and ASIC in formulating their regulatory risk strategies and IFSA also looks forward to regulator decisions to implement changes in resource allocations that result in efficiency dividends. The Government's statement of expectations will no doubt assist in this process, as will meaningful consultation between the regulator and the regulated on future risk and resourcing needs.

Recommendation 10

IFSA recommends that:

1. the industry levy should be based on the risk rating of the entity;
2. the levy should be reflective of the actual costs incurred in supervising entities regardless of asset size; and
3. measures put in place to monitor and report on the allocation of resources by the regulator to achieve efficient resource management.

11. Whether promotional advertising should be a cost to a fund and, therefore, to its members.

Principle 11

1. Advertising is essentially a commercial matter and the determination of member benefit is a difficult question that without further clarification will be subject to debate and inconsistent practice.

2. ASIC is not a competition regulator. Regulatory responsibility for the regulation of financial services industry advertising should be transferred from ASIC to the Australian Competition and Consumer Commission (**ACCC**).

Superannuation funds and their trustees are required to comply with the 'sole purpose test' requirement of section 62 of the SIS. The object of the sole purpose test is to ensure that regulated superannuation funds are maintained for the purpose of providing benefits to persons upon their retirement, or their dependants in the case of a person's death before retirement. The trustee of a regulated superannuation fund must comply with the sole purpose test to attract the taxation concessions available to a complying superannuation fund.

An APRA letter to trustees dated 14 March 2005 has provided some guidance on the relkationship between the sole purpose test and advertising expenditure by superannuation funds:

> **[Marketing to retain existing members and/or recruit new members**] *In our view, imposing marketing expenses on current members primarily to attract new members is difficult to justify; imposing marketing expenses on current members where the benefit of such an expense falls primarily to the trustee (by way of enhanced remuneration) or other parties would be inconsistent with the sole purpose test and may give rise to inequities among generations of members;*

This statement gives rise to uncertainty in the post choice marketplace as funds compete for new members. Accordingly, we recommend that if Government considers that certain types of advertising for fund purposes can be paid for from fund assets then, it should expressly identify in the law permitted advertising.

ASIC and Misleading advertising

ASIC has taken a aggressive stance in relation to advertising by the retail funds sector. On the one hand it has held that the use of past performance information in advertising and promotional material is misleading (ASIC Media Release, Wednesday 9 August 2006) while permitting financial projections to be used dominantly in advertising with minor qualifications and continuing to accept generalised comparative statements on fees as the primary differentiating factor in financial returns.

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IFSA considers that the consumers and the market place for financial products, including superannuation, would be better served by the Australian Competition and Consumer Commission (**ACCC**) regulating financial services industry advertising. The ACCC is familiar with structures and arrangements in the industry and has the necessary expertise to regulate advertising. ACCC procedures are driven by a long corporate history of regulation in this area, by a strong body of case law, and ACCC has specialist and expert staff who, on a day to day basis, deal with these matters. It is noteworthy that ASIC, on its FIDO consumer website, states that "To resolve your problem quickly it is important to find the right organisation to help you. A simple check now can prevent delays later. The questions below will help you to decide who can deal with your complaint", and then at question 3 directs the user to with a complaint about advertising to the ACCC[16].

Recommendation 11

1. The law should be amended to list the types of advertising that can be paid for from superannuation fund assets by fund operators.

2. Regulatory responsibility for the regulation of financial services industry advertising should be transferred from ASIC to the Australian Competition and Consumer Commission (**ACCC**).

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[16] See www.fido.asic.gov.au

Is your complaint about:

- **prices**
- **competition**
- **unfair market practices**
- **product safety**
- **franchises**
- **advertising**
- **online shopping?**

If so, you should contact the Australian Competition and Consumer Commission (ACCC) or State Government consumer bodies. For more information visit the ACCC website or your State consumer agency listed above.

ACCC website: http://www.accc.gov.au

See ACCC's website www.consumersonline.gov.au for information regarding online shopping.
Complaints in relation to overseas based businesses are dealt with by econsumer.gov.

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12. The meaning of the concepts "not for profit" and "all profits go to members"

Principle 12

The terms "not for profit" and "all profits go to member" and like expressions should only be used where they are completely accurate or properly qualified.

Retirement savings are managed by a variety of entity types, some are public or private companies others are mutual entities.

In the context of superannuation the terms "not for profit" and "all profits go to members" have been used in connection with mutual funds. Mutual entities differ from companies that are driven by creating value for shareholders by distributing profits in that they are associations of persons who have joined together to achieve a benefit in which all members participate or are entitled to do so. As they do not have shareholders they do not have a requirement to distribute profits. The investment returns of mutual entities are attributed to members investment accounts after covering the expenses of operation, either by the mutual itself or as payments to outsourced service providers which themselves may be public or private companies.

As noted in the June 2006 Analysis publication of Rice Walker Actuaries, "While the trustees of not for profit funds do not seek to profit from the activities of the fund, they are still influential in allocating the income of the fund to various activities". Those activities may generate income and profit for the providers of services to a superannuation fund.

Fees paid in a superannuation context eventually end up in the hands of individuals, whether shareholders, employees, or service providers further down the chain. The fundamental issue and responsibility of trustees is not whether the remuneration paid is "for profit" or "non-profit", but rather whether it is "reasonable" or "excessive" reward for the activities performed for the fund. The principle that the trustee act in the best interests of members is enshrined in law. "Not for profit" entities can pay excessive rewards for services just as much as "for profit" entities.

Recommendation 12

That the terms "not for profit" and "all profits go to members" and like expressions should only be used where they are completely accurate or properly qualified.

13. Benchmarking Australia against international practice and experience

Principle 13

Australia should seek to have the most efficient and equitable superannuation savings and pensions regime possible.

Dealing with the pressures of ageing populations

Due to the fiscal pressures of an ageing population and the need to improve adequacy of retirement income arrangements, most developed countries have now moved to a multi-pillared approach to the provision of retirement income, shifting the burden of provision from the state to employers and individuals. Fourteen out of thirty OECD countries now have mandatory or quasi-mandatory funded pension schemes in addition to traditional and many countries are also offering incentives to encourage voluntary retirement savings.

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Australia's three-pillar approach to retirement incomes, comprising compulsory and voluntary private savings, and a means-tested, publicly funded age pension, has been endorsed by the World Bank[17] and other international bodies as a model which offers the best prospect of being fiscally sustainable and providing higher incomes in retirement. In this regard Australia is ahead of the pack.

The three pillar system ensures Australia is well placed in terms of its ability to cope with the ageing of the population compared to other developed countries which have traditionally required employees to participate in unfunded employment or earnings-related retirement income schemes. There are a number of features of Australia's retirement income system that ensure it compares favourably to those of other countries.

Superannuation coverage in Australia rates highly compared to the private retirement savings plans of other countries. In Australia, 90% of the workforce is covered by superannuation, while the proportion of workers covered by private plans is 45% in the US, 60% in the UK, and 40% in Canada.[18]

The Australian Government provides significant incentives for individuals to save voluntarily through superannuation. These incentives are provided by way of concessional rates of income tax and co-contributions for low and middle income earners.

As part of the May Federal Budget, the Treasurer announced reforms that will boost these incentives by way of removing tax on end benefits for individuals over 60, extending concessional tax treatment of superannuation and co-contributions for the self-employed and reducing the age pension assets test taper rate. The Australian age pension means test (comprising of an income test and an assets test) ensures that the pension is appropriately targeted to those most in need while remaining affordable for the Government. These reforms are also aimed at removing significant complexity in the superannuation tax arrangements, improving the adequacy of retirement income and providing greater incentives for older workers to remain in the workforce.

In terms of dealing with the fiscal pressures of an ageing population while promoting higher incomes in retirement, Australia's system is fairly advanced. Many of the challenges faced by other countries are not significant concerns for Australia. We should, therefore, proceed with caution when considering adopting features in other systems in isolation as there is a potential to undermine the integrity of our own system.

Costs of regulation

Australia's superannuation regulatory framework is well-regarded by overseas jurisdictions for providing a relatively safe and secure investment environment for superannuation fund members. We also have a strong competitive market offering employees a choice of superannuation fund and portability of benefits. Recent financial services reforms have also brought about greater levels of transparency and disclosure to fund members.

A big challenge facing the Australian superannuation system is ensuring that the regulatory environment keeps pace with industry change and that the benefits of any regulatory change outweigh the costs. We consider that Australia's the costs of regulation in the Australian superannuation industry should be benchmarked against the costs of regulation in the retirement income systems of other jurisdictions to ensure our industry is internationally competitive.

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[17] World Bank, *Averting the Old Age Crisis – Policies to Protect the Old and Promote Growth*, Oxford University Press, 1994.
[18] H.Bateman and G. Kingston, *Comparative Performance of Retirement Income Systems in the Anglosphere,* School of Economics, University of New South Wales, April 2005.

As the table below demonstrates, Australia is relatively well placed compared to other countries in terms of the ability of the retirement system to cope with this ageing of the population, especially in contrast with nations such as Japan and Switzerland whose old age dependency rates are projected to increase to markedly higher levels.

Funding levels compared

Country	Total pension assets ($US billion)	GDP 2003 (US$ billion)	Total pension assets as % of GDP	Population (millions)	Total pension assets per capita (US$)	Old age dependency rate (%) 2000	Old age dependency rate (%) 2030 (projected)
Australia	426	514	83%	20	21,657	18	32
Japan	2,463	4,301	57%	127	19,328	25	52
Netherlands	545	513	106%	16	33,820	20	40
Sweden	226	302	75%	9	25,322	27	46
Switzerland	319	316	101%	7	43,753	24	53
UK	1,266	1,795	71%	59	21,454	24	40
US	7,438	10,857	69%	289	25,773	19	33

Source: UBS Global Asset Management publication. Data is based on GDP and population data from OECD. Old age dependency rate is population aged over 65/population in working age (15-64), expressed as a percentage. Total pension asset data at 31 December 2003 unless stated otherwise: Australia: APRA. Japan: Japanese Ministry of Health, Labour & Welfare, UBS Global AM estimates (31 March 2003). Netherlands: CBS (30 September 2003). Sweden: Government of Sweden. Switzerland: Bundesamt für Statistik (31 December 2002). UK: UBS Global AM estimate based on National Statistics data. US: Federal Reserve.

However, accumulated superannuation contributions alone are unlikely to provide an adequate retirement income for most Australian workers, with many set to retire on less than half their average salary, well short of the 65 percent to 75 percent of their current income retirement planners generally estimate that retirees need.

Awareness among pension providers of developments beyond their own national borders has heightened considerably. In Europe in particular, the moves towards a pensions directive engaged the interest of national governments and scheme sponsors alike. Early drafts included quite prescriptive investment restrictions which were unacceptable to several member states.

The cross-border pension fund rules finally approved by EU ministers in 2003 leave funds broadly free to decide their investment strategy. The Directive became EU law in September 2003. It is clear that investment strategies, and pension provision in general, are on the road to becoming more homogeneous in Europe and, indeed, around the world.

Recommendation 13

1. Government should continue to build an effective and efficient superannuation system in Australia in close consultation with industry.

2. The regulatory costs of the Australian system should be benchmarked against international best practice.

14. Level of compensation in the event of theft, fraud and employer insolvency

Principle 14

In a competitive market where investor choice operates guarantee and insurance arrangements are inappropriate where they effectively penalise good corporate citizens and increase the risk of failure by marginal operators.

Existing compensation arrangements under Part 25 of SIS in the event of theft and fraud are an appropriate regulatory response to criminal activity of this nature. Member protection is, however, reliant on diligent trustees and effective prudential regulation.

IFSA is aware that various recommendations have been made to Government to introduce limited compensation schemes within the financial services industry[19]. Our responses to those recommendations are equally applicable to the issue posed under this item. Essentially, the IFSA response has been:

1. to support for basic legislative mechanisms to underpin Australia's failure management arrangements, but not to support the setting up of a limited but explicit industry funded guarantee scheme;
2. in the event that an industry solution to institutional failure is not developed on a case by case basis, we consider that it is appropriate for Government to step in and provide short term liquidity such as that envisaged under the proposal with those costs being recovered to the extent of available assets;
3. even a partial guarantee will not reduce the potential for systemic risk if a significant player fails.

What a guarantee is likely to do is:

- to increase competition from product providers who are not risk averse;
- provide comfort to investors/policyholders/clients who may be encouraged because of the guarantee to invest with riskier entities; and
- provide support for riskier business activities at the expense of efficient and well run organisations.

Generally, IFSA considers that the case has not been made for the introduction of a guarantee scheme over and above the existing:

- depositor preference arrangements for ADIs;
- life insurance statutory funds;
- priority arrangements for insurance policyholders; and
- compensation arrangements under Part 23 of the SIS Act.

Proposals for further guarantee arrangements may be a politically expedient solution for Government to calls for support in the event of institutional failure, they do not address the broader economic impacts on market behaviour in terms of competition, efficiency, cost and moral hazard inherent in the proposal.

In circumstances where regulatory failure is identified as a significant contributor to institutional failure, Government intervention and support is not an unreasonable community expectation. Guarantee proposals potentially shift a significant cost burden onto otherwise 'innocent' parties - competitors in the same industry sector and, to their shareholders and members. The imposition

[19] Government Discussion Paper on Financial System Guarantees

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of a financial system guarantee on industry, even where levy arrangements are triggered only after the event, will result in additional costs to industry that will be passed to policyholders. Hence, the net effect of any limited explicit guarantee would be to shift the financial burden to a smaller taxpayer base, rather than a fairer distribution to taxpayers at large.

It should be noted that well run organisations expend a significant amount of time, money and attention on internal systems to comply with industry regulation and meet the needs of their customers. Any intervention by a regulator will generally have a commercial impact on business. Likewise, any action by Government to introduce a financial system guarantee will undermine that investment by industry and will, in our view, have the effect of diminishing consumer trust in industry thereby increasing moral hazard.

In summary, the introduction of any explicit financial system guarantee will:

- result in increased cost to customers;
- reduce standards by underwriting inefficiency/complacency;
- increase the risk of failure;
- be anti-competitive;
- result in more claims on a fund because customers have less incentive to be risk averse; and
- diminish trust in the industry.

Conclusion

If the Committee was to recommend the introduction of any broader compensation arrangements for institutional failure, we would recommend that a legislative scheme be limited to provision of short term funding by the Reserve Bank, administered by APRA, with costs being recovered by the sale of assets of the failed institution. Such legislation would remove the need for special purpose legislation to be introduced on a case by case basis, provide for the orderly wind-up of the institution, and alleviate the immediate consumer impact. The solution is readily transferable to an employer insolvency situation and to the extent that funds cannot be recovered they should be borne generally by the public from Government revenue.

Recommendation 14

IFSA recommends that there should be no expansion of the existing compensation arrangements under the law. If the existing scheme is expanded any failure should be funded by Government.

15. Any other relevant matters

15.1 A Single Disputes Resolution Scheme

The Financial Services industry is characterised by a number of different dispute resolution schemes. The ASIC website lists 8 different schemes and, of course, there is provision for ASIC to approve further schemes.

Given the size of the Australian market it would be in the interests of both industry and consumers to rationalise the number of schemes where they effectively cover the same ground.

1. **Financial Industry Complaints Service (FICS) -** FICS deals with complaints about financial services providers including life insurers, funds managers, investment advisers and planners, stockbrokers and some superannuation providers.

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2. **Insurance Ombudsman Service Limited (IOS) -** IOS deals with complaints about general insurance companies.

3. **Banking and Financial Services Ombudsman (BFSO) -** BFSO deals with complaints about financial services providers including banks, foreign exchange dealers, deposit takers, credit providers, mortgage brokers and some insurance and investment providers.

4. **Credit Union Dispute Resolution Centre (CUDRC) -** CUDRC deals with complaints about most Australian credit unions.

5. **Insurance Brokers Disputes Limited (IBD)** - IBD deals with complaints about general or life insurance brokers.

6. **Financial Co-operative Dispute Resolution Scheme (FCDRS) -** The FCDRS deals with complaints from consumers about those Australian credit unions and building societies who are members of the scheme.

7. **Credit Ombudsman Service Ltd (COSL) -** COSL deals with complaints about individuals and companies that operate in the credit industry and are members of the scheme. (Formerly called the Mortgage Industry Ombudsman Service)

8. **Superannuation Complaints Tribunal -** The Superannuation Complaints Tribunal (SCT) is an independent tribunal set up by the Commonwealth Government to deal with complaints about superannuation funds, annuities and deferred annuities, and retirement savings accounts. If all of the financial services you provide are covered by the SCT, you do not have to join an approved external dispute resolution scheme.

Recommendation 15.1

IFSA recommends that Government reduce, through consolidation, the number of existing external dispute resolution schemes available to consumers.

15.2 Removal of the requirement for Policy Committees for public offer superannuation funds offering investment choice

Policy Committees were a recommendation of the Senate Select Committee on Superannuation in its report Safeguarding Super – The Regulation of Superannuation (June 1992). Recommendation 5.6 of the report was “that each individual plan or sub-plan with arm’s length members in master trust arrangements be required to have a policy committee comprising equal representatives of employers and employees to advise the trustee”.

While the requirement served a useful purpose as a transitional matter IFSA does not believe that the SIS requirement for a policy committee should apply to a trustee where:

- it is an independent trustee of public offer funds;
- the investment strategy of the fund provides for individual beneficiaries to give directions to the trustee (ie the fund is a master trust);
- the directions relate to the strategy to be followed by the trustee in relation to the investment of a particular assets or assets of the fund; and
- the directions are given in circumstances covered by regulations made for the purposes of paragraph 52(4)(b) of SIS.

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The functions of a policy committee are set out in regulation 3.06. The following comments are made in relation to the requirements in terms of their relevance to a public offer fund with individual member investment choice.

1. **Provision** 3.05(a)(i) - provides an avenue for members of the fund to inquire about the investment strategy and performance of the fund;

Comment - not applicable/irrelevant, as members of policy committees do not by virtue of that position have access to information about the performance of the investments in an individual member's Account. This is a fundamental tenet of the Federal Government's Privacy legislation. So, it is clear that a policy committee simply cannot fulfil this function where there is individual member investment choice.

2. **Provision** 3.05(a)(ii) - provides an avenue for the trustee of the fund to obtain the views of members of the fund concerning that strategy and performance.

Comment - This provision is not applicable or relevant, as members have individual investment choice.

3. **Provision** 3.05(b) – provides an avenue for members of the fund to inquire about the fund's operation or performance.

Comment - This provision is not applicable or relevant for the reasons given above. In any event, members will have direct access to a trustee's investor services function, whose day to day responsibility it is to deal with member enquiries of this nature.

4. **Provision** 3.05(c) - provides an avenue for the trustee of the fund to obtain the views of members of the fund concerning the fund's operation or performance;

Comment - This provision is not applicable or relevant to a master fund trustee as it can only deal with individual members in relation to their Account and the performance of their Account.

5. **Provision** 3.05(d) - provides an avenue for the trustee of the fund to obtain the views of members of the fund on their information needs;

Comment - Again, a master fund trustee only usually ever deals with individual members in relation to these matters and all periodic reports and the fund's Annual Report go direct to individual members, so it has little or no relevance in the master trust context.

6. **Provision** 3.05(e) - assists the trustee of the fund in dealing with complaints.

Comment - again, for privacy law reasons, the trustee would never normally share information about an individual member's complaint with a policy committee and would only ever deal with an individual member, or their financial adviser in relation to a member complaint. So, access to a policy committee for this purpose has no practical application.

In the master trust context, current privacy law (which post-dates the policy committee provisions of SIS) severely affects the utility of the policy committee provisions as a whole.

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Recommendation 15.2

IFSA recommends the removal of the requirement on a public offer fund trustee to take all reasonable steps to establish a policy committee is removed. Regulations could still specify how a policy committee is to operate, if established.

15.3 Unit Pricing - Distribution of Investment Earnings

Principle 15.3

The valuation of interests in superannuation funds should be subject to a uniform unit pricing methodology. The Government should mandate transitional arrangements for unit pricing.

IFSA believes that the most appropriate way to allocate investment earnings to investors is through the use of unit prices (in most circumstances calculated on a daily basis). This is the most equitable structure as an investor gets credited with the actual investment amount earned on their assets. It also gives the investor certainty as to what their account balance is at any point in time.

IFSA has established standards with respect to Scheme Pricing (IFSA Standard No.8.00), the valuation of Scheme assets and liabilities (IFSA Standard No. 9.00) and provided guidance on what fund managers should follow if investors are disadvantaged by incorrect calculations relating to unit pricing (IFSA Guidance Note No. 4.00 to be made into a Standard following a review by IFSA). Those standards and guidance are currently subject to review by IFSA following the joint release of the *Unit Pricing – Guide to Good Practice* (Guide) for the life insurance, superannuation and funds management industries by ASIC and APRA in November 2005. The Guide outlines a range of good practices and has been developed following a joint review by APRA and ASIC of unit pricing practice, aided by extensive industry consultation. IFSA will consult with APRA and ASIC before finalisation of the new standards. Copies of the draft documents are at **Attachment E.**

There are a range of methods used by providers in the industry to allocate investment earnings. The most common approach is to use unit prices however a number of providers (including many industry funds) still use crediting rates to allocate investment earnings. This means the crediting rate applied is always an estimate of the investment earnings over the period and inequities can result. Individuals will always be better or worse off in a given period under this structure than under daily unit pricing.

Rice Walker[20] has recently examined this issue and has shown that there can be significant mis-allocation of investment earnings in any particular period. This can be particularly problematic for an investor who is looking to invest a large lump sum or rollover. Under Choice of Fund, with increased investor movement in and out of superannuation funds, this is clearly an issue for investors. Our view is that unit pricing is the most equitable allocation method, as investors are credited with the actual returns earned on their investments from the day they invest.

Attachment D provides a hypothetical example of the impact of crediting rates could have on an investor. Using an investor with $100,000 invested in an Australian share fund on 1 July 2004 and withdrew it in December 2004. In this example, in one extreme, an investor who left on 9 December 2004 would be over-credited $588 (or 0.6%). At the other extreme, a member who left on 23 December 2004 would have been over-credited $3,007 (or 3.0%).

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[20] Langton G, "Equitable Distribution of Investment Earnings in Collective Investments", *Rice Walker Actuaries*, June 2005

This example shows that the crediting rate system can cause unnecessary inequities that are material to the investor's level of return. Under Choice of Fund, with increased investor movement in and out of superannuation funds, this is clearly an issue for investors. Our view is that unit pricing (preferably daily) is the most equitable allocation method, as investors are credited with the actual returns earned on their investments from the day they invest.

Recommendation 15.3

IFSA recommends that:

1. extant products in the superannuation choice environment be required to implement a uniform unit pricing methodology for the valuation and allocation of investment returns.

2. closed funds and legacy products using crediting rates should be excluded from this requirement as the requirement would present unreasonable costs.

15.4 Product Rationalisation

Australia has a well-established financial services industry with a long history of innovation. A benefit of this is the availability to customers of a large range of financial products that have been developed to meet market changes and changing lifestyle, taxation and consumer priorities.

The financial services industry in Australia has, particularly since the early 1980s, been subject to significant legislative reforms and technological changes in both administration and delivery of investment services to customers. A legacy of the legislative, regulatory, and tax changes since the 1980s has been an increase in the number of financial products that are closed to new clients and that operate on old computer systems which are increasingly difficult to support. Inevitably, the numbers of technical staff most familiar with these products are dwindling, and the cost of maintaining an increasing number of products and systems is becoming a drain on the industry. This increases both costs and product risk to industry and customers. Additionally, these problems have been exacerbated by industry consolidation and merger activity.

While the superannuation and life insurance regimes do contain mechanisms enabling product rationalisation, the respective regimes[21] tend to involve lengthy and costly processes that in fact inhibit product rationalisation.

The Financial Services Reform legislation was designed to better protect customers and equip the Australian financial services industry to compete in the 21st century. It is now an appropriate time to continue those reforms and to introduce a single legislative mechanism to assist financial product providers to maintain modern infrastructure systems to enable their operations to keep abreast with technological change and more efficiently meet the needs of customers. Modern technology platforms provide customers with the benefits of greater efficiency, reduced cost and more choice.

IFSA submitted a comprehensive proposal to Government in May 2005. That submission was followed by a further submission in the form of an industry regulatory impact statement, in response to the Government's *Consultation Paper : Corporate and Financial Services Regulation Review (April 2006).*

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[21] Successor Fund Regime under Part 18 of the *Superannuation Industry Supervision Act 1993* and Part 9 of the *Life Insurance Act 1995*.

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Financial products to which this rationalisation proposal is primarily directed are managed investment schemes, superannuation funds and life insurance products. While the superannuation and life insurance industries are able to rationalise financial products under existing laws, those requirements need to be reviewed and, in our view, incorporated into a single financial product rationalisation regime that reflects the legislative approach under the new financial services laws. ASIC is responsible for market conduct for each of these products under the *Corporations Act 2001* (**Corporations Act**), while APRA is the prudential regulator for superannuation and insurance products under the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**) and *Life Insurance Act 1995* (**Life Act**).

IFSA has undertaken extensive consultation in the preparation of proposals that will facilitate industry efficiency, reduce risk and benefit customers. IFSA considers that a high priority should be attached to Government by this proposal and encourages the Inquiry to consider it within the terms of its Inquiry.

Recommendation 15.4

That the Government adopt the IFSA legislative proposal for product rationalisation

15.5 Calculators

Principle 15.5

"Promote the provision of basic on-line calculators to enable consumers to understand and compare financial products and services ***without that being classed as personal advice****".*

Calculators is an area where the intention of the Government to ensure consumers receive information that is relevant to their needs; reduce the compliance burden on industry and clarify the intent of the legislative and regulatory framework that applies to the financial services industry[22] has been marginalised by ASIC. The Principle stated above is a direct quote from the Treasury proposals paper *Refinements to Financial Services* (May 2005).

The Government proposal was that the provision of basic on-line calculators that provide personal advice should be treated as if they do not. Why are calculators subject to the advice provisions of the Corporations Act? ASIC states in its Regulatory Impact Statement to Class Order 05/1122[23] that:

> "Generic calculators typically require the user to input information about their financial objectives, financial situation or needs (e.g. information about their initial investment, investment timeframe, ongoing investments, salary, age etc). The generic calculator then uses this information to generate a result. In doing so, the generic calculator has taken into account at least one aspect of the user's objectives, financial situation or needs. For these reasons, the financial product advice provided by many generic calculators is likely to be personal advice. If the calculator provides personal advice to a retail client, the provider must comply with the personal advice aspects of the conduct and disclosure regime."

22 Treasury's May 2005 paper *Refinements to Financial Services*
23 issued on 15 December 2005

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The ASIC relief does not apply to product specific calculators or risk profilers. The submission of IFSA members is that where a calculator provides financial product advice, relief is required from the consequences of providing personal advice. Industry submits that relief should only be provided to a person who is authorised by the law to provide that financial product advice. They should have an AFSL or be the authorised representative of an AFSL holder. This will promote the development of calculators and provide protection to consumers in a regulated environment.

The Act has provided significant consumer protection by ensuring that only an appropriately licensed or authorised person can provide financial services. Under the ASIC relief, a person without an AFSL is able to provide financial product advice through a calculator. We do not support this outcome.

IFSA acknowledges that relief should be subject to conditions that ensure that consumers understand the purpose and limitations of calculators.

It should be noted that an individual generic calculator may provide no advice, general or personal advice. A calculator that names a particular fund and uses its actual fees and, say guaranteed returns to provide a mathematical output may merely provide factual information. It will depend on the presentation of the particular calculator, any opinions it expresses and representations it makes, not the fact that it identifies a particular fund.

ASIC relief does not extend to investment risk profilers that in our view perform the same function as calculators. They provide consumers with information relevant to their needs, they assist consumers to understand and compare financial products. In our opinion, the consumers who are likely to be the best informed about their financial needs, and who will be best able to make decisions about financial products, including when to seek financial product advice from a licensed provider are those who have access to investment risk profilers and calculators. Consequently, financial services providers are, in our view, able to offer consumers the most valuable and complete educational tools, if they can make available to them various investment risk profilers and calculators at the same time.

Providing limited and piecemeal relief will not promote the policy objective to "*work with industry to equip consumers with the information needed to make informed financial decisions*" whether generally or in relation to a particular financial product.

It should be noted that well-designed calculators can play an important role in assisting consumers to make informed financial decisions without charge or obligation. They enable users to gain a better understanding of their financial needs, the features available from different types of financial products and classes of products, and the factors which will have an effect on the performance and returns of their long term investments.

It is important to the industry that calculators serve to educate users about the factors affecting investment performance and the returns that are reasonable to expect.

Recommendation 15.5

IFSA recommends that the relevant provisions of the *Corporations Act 2001* (**Act**) be modified by introducing new regulations under section 926B and section 951C of the Act to exempt providers of calculators, including investment risk and insurance risk profilers which provide personal advice, from the obligations under Parts 7.6 and 7.7 of the Act to the extent that they apply to a person providing personal advice. The exemption could be subject to conditions set out in the regulations. One such condition could be that the provider complies with industry standards developed in consultation with ASIC.

15.6 Section 1012IA – custodial arrangements

Section 1012IA has presented the superannuation master fund industry with serious operational issues since its enactment. The section requires a PDS to be "given" to a client of a custodial arrangement for underlying financial products before acquisition. To date, this has been addressed through ASIC Class Order relief issued on an interim basis that exempted such funds from the operation of section 1012IA (ASIC Class Order [CO 03/1097] *Deferral of s1012IA)* on the basis that:

> *the provider takes all reasonable steps to ensure that any document given or made available to a client by or on behalf of the provider which specifies a particular financial product which may be acquired under the custodial arrangement and for which a Product Disclosure Statement may, but for this exemption, be required to be given under subsection 1012IA of the Act:*
>
> > *(a) includes or is accompanied by written information about how the client can obtain a copy of the Statement for the product; or*
> >
> > *(b) in the case of a document given or made available through the Internet or otherwise in an electronic form — prominently draws attention to information about how a copy of the Statement for the product may be accessed, for example by including a hypertext link to that information in a prominent place.*

On 2 August 2006, ASIC issued Class Order 06/636. That Class Order followed the release by ASIC of Policy Statement 184 - Superannuation: Delivery of product disclosure for investment strategies (dated 6 June 2006). The Policy Statement and Class Order are expressed to be ASIC's final policy on this matter.

While ASIC has indicated that it received and considered various submissions on its earlier Policy Proposal Paper (11 November 2004) on this matter, there was no consultation with industry on the final form of the Policy or class order. The end result is that despite ASIC's assertion that the application of section 1012IA via the class order relief would have "minimal impact" on the superannuation industry, the application of section 1012IA raises significant practical, resourcing, legal and compliance obligations and increased costs for product issuers (and therefore potentially for investors) without any meaningful additional benefit in terms of disclosure for investors.

ASIC's final position indicates the perceived limits by ASIC on its ability to provide relief on this matter. As far as IFSA is aware, superannuation master trusts have operated effectively under the conditions of the previous ASIC Class Order without any detrimental impact on members. That relief required a trustee to ensure that members had access to the PDS of product issuers making their financial products available through the superannuation master trust.

IFSA recommends that section 1012IA be clarified to require the provider of the custodial arrangement to ensure that a client has access to the PDS of an asset to be acquired through the custodial arrangement before the acquisition. This could be done by amending section 1015C of the Corporations Act by adding subparagraph 1015C(1)(a)(iii) to provide:

> (iii) for the purposes of section 1012IA, accessible by a person, or person's agent, through the Internet or otherwise in an electronic form.

Recommendation 15.6

The Government should amend the operation of section 1012IA of the *Corporations Act 2001* to provide that where as part of a custodial arrangement a client has access to Product Disclosure Statements (**PDS**), arranged by the provider of the custodial arrangement and brought to the attention of the client, the obligation on the provider to give the client a PDS for investments available through a custodial arrangement is satisfied.

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ATTACHMENT A

IFSA - Towards Better Regulation
Policy on future regulation of Financial Services in Australia

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IFSA – Towards Better Regulation

Policy on future regulation of Financial Services in Australia

23 February 2006

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1. INTRODUCTION

This document is the Headland Statement (2006 – 2008) for the IFSA Regulatory Affairs Board Committee. What is a Headland Statement? Very simply, it is a statement that:

- acknowledges our past – where we have come from;
- looks critically at where we are now; and
- looks forward - describing our mission, where we want to be and how we propose to get there.

The IFSA Regulatory Affairs Board Committee ('**Committee**') has the broadest mandate of the 6 IFSA Policy Board Committees[1]. The Committee is responsible for developing IFSA's strategies and policies in relation to existing and proposed regulatory issues affecting the financial services industry[2].

The primary aim of the Committee is to engage the Government and the regulators to better improve financial services regulation in Australia for the benefit of the investing public and assisting in the efficient operation of the financial services industry. Our primary method to achieve this is "effective communication".

As at 1 January 2006, IFSA members manage approximately $920 billion worth of assets representing the growing investments and savings of over 9 million Australians. Our members are tasked with maximising the returns to customers, and are judged on their ability to deliver on those returns in a highly competitive market. Minimising costs and maximising returns for the benefit of customers' remains at the heart of what our members do.

Our concern, which is shared by Government, is that the increasing volume of rules and black letter law has come at a great financial cost to industry and our customers[3]. There needs to be a shift in regulatory design and process. IFSA recommends that a three pronged approach to regulation be pursued. This approach will involve:

(a) greater reliance on the development of industry **codes of practice and self enforcement**;

(b) the introduction of a **formal consultative process** for proposed regulatory changes and reform proposals; and

(c) greater emphasis and reliance being placed on the analysis of costs and benefits of regulatory proposals.

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[1] Regulatory Affairs Board Committee, Economic Savings and Tax Board Committee, Marketing and Distribution Board Committee, Investments Board Committee, Life and Risk Management Board Committee, Infrastructure (Operations and Technology) Board Committee.

[2] The mandate and operations of each Board Committee are provided separately in IFSA Guidelines.

[3] See current tasks of Financial Sector Advisory Council (**FSAC**) – 1998 and the newly established Taskforce on Reducing the Regulatory Burden on Business – 2005

2. OUR PAST AND THE PRESENT

What we now call "Financial Services Regulation" in Australia has come a long way in the last 50 years. It is a story of innovation and changing regulation[4].

Our existing regulatory structure has its genesis in the recommendations of the Financial System Inquiry[5] (**FSI**). It would be true to say that in 2006, we are still working towards the regulatory regime recommended by the FSI in March 1997.

The *Financial Services Reform Act 2001* (**FSRA**) replaced a piecemeal legal framework that had developed over time. From 11 March 2001, a harmonised regulatory regime for consumer protection and market integrity was introduced into the law. FSRA was broadly supported by our industry and was the culmination of more than four years' work with Government.

The policy aim of the FSRA reforms was to:

- deliver an effective and responsive regulatory regime that would deliver maximum benefits to industry, consumers and the economy as a whole;
- provide greater competitive neutrality across the financial services industry; and
- remove inefficiencies created by overlaps and gaps in fragmented regulation.

The stated policy aim of FSRA serves as a benchmark for the Regulatory Affairs Board Committee against which it can evaluate proposed changes to the law and practice.

3. INDUSTRY ISSUES

3.1 Current Issues

Our industry is both dynamic and evolving. Current significant legislative issues for the financial services industry include:

- continuing financial services reforms;

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[4] Fifty Years of Managed Funds in Australia, Preliminary Research Report by Bernard T Mees, Monica S Wehner, Pamela F Hanrahan, Centre for Corporate Law and Securities Regulation, University of Melbourne, September 2005

[5] The Treasurer announced on 30 May 1996 the establishment of an Inquiry into the Australian financial system, to report to him by 31 March 1997.

> *The Inquiry is directed to provide a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. The Inquiry will make recommendations on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.*

- product rationalisation as legacy and sub-scale financial products give rise to additional costs and risks;
- proposed anti-money laundering legislation; and
- adoption and application of International Financial Reporting Standards.

Each of these items constitutes a separate topic for discussion and each is indicative of the type of major reform issue that has arisen in the past and will continue to arise in the future

It is important that the legislative and regulatory solutions do not result in over regulation imposing significant cost and technical burdens on industry. **Style** and the **cost of regulation** are a fundamental consideration in being able to achieve focussed and efficient regulatory measures.

3.2 Style of Regulation

FSI was clearly in favour of a principle based regulatory regime or, at least, a regime which comprised a large proportion of high level principle based regulation. Recent legislation, in particular the FSRA has evolved away from the principles based approach envisaged by the FSI, towards a far more rules based model. Notwithstanding ongoing references by regulators and Government to FSRA as 'principle based', industry's view is that FSRA has finished up as rules based regulation.

The reason for the trend towards rules based regulation may have simply been that industry was not prepared to accept the responsibility that went with a principle based approach, although it is more likely that it was simply a style that has developed within Government drafters and regulators. Whatever the causes of the trend, the result is both costly and inefficient for industry and has not provided commensurate benefits to the investing community. Contrary to its objective, the rules based approach to regulation creates uncertainty in market participants encouraging them to become risk averse at the expense of their customers. Market participants under a rules based regime will continuously seek external reassurance and 'guidance' before acting.

The rules based approach is problematic in a world where products and services continue to be largely technology driven. Such an approach can be a dead hand on technology and product innovation. In the highly competitive domestic and global of financial services environment, regulation must be flexible enough to meet constant changes.

If Australia is to continue to reap the benefits of innovation it must have a regulatory regime that is supportive. An Australian principle based regulatory regime will be able to more readily adapt to changes in delivery of products and services through technological advances than will prescriptive rules based regulation.

3.3 Cost of Regulation

The cost of regulation is an issue which indirectly affects our customers. While product and service providers have and will continue to absorb some costs, the reality is that a significant portion will be passed onto customers. Unnecessary costs erode

future savings. FSI considered that Australia's regulatory costs in 1997 were high, with only the US having higher compliance costs. The report estimated total compliance costs in Australia as exceeding $720 million, equivalent to 7.6 basis points of assets.

Since 1997 there have been a series of major legislative reforms commencing with the *Managed Investments Act 1998* through to the *Financial Services Reform Act 2001*[6] and finishing with the Superannuation Safety[7], Superannuation Choice[8] and CLERP 9[9] Acts. Each Act had a major impact on industry structures and involved a significant additional compliance element.

The IFSA Key Industry Statistics Surveys for the last 5 years have shown that there have been significant increases in the costs to industry in the areas of information technology, regulatory compliance and customer service. The current cost for IFSA member companies to comply with the financial service industry regulation is about 10 to 15% of total operational costs.

Given that even minor regulatory changes will now generally involve some changes to the technology and operational systems underpinning the delivery of products and services, the compliance costs of relatively small regulatory changes may be quite high. The Committee, on behalf of the industry, must seek to ensure that the costs of change do not exceeded the perceived benefits.

4. EFFECTIVE CONSULTATION

To address the regulatory trend for more rules and black letter law there needs to be a shift in regulatory design and more effective consultative processes.

The three pronged approach recommended by IFSA will involve:

(a) greater reliance on the development of industry **codes of practice and self enforcement**;

(b) the introduction of a **formal consultative process** for proposed regulatory changes and reform proposals; and

(c) greater emphasis and reliance on the analysis of costs and benefits of regulatory proposals.

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6 The Financial Services Education Agency Australia (**FS**EAA) reported by Media Release dated 13 December 2005 that just to get a complaint under FSR has cost Australia's licensed Financial Services providers more that $224 million. The survey was undertaken by Victoria University, funded by the Taxpayers Research Foundation Ltd, and supported by **FS**EAA.

7 Superannuation Legislation Amendment (Superannuation Safety and Other Measures) Act 2005

8 Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004

9 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004

4.1 Codes of Practice

Since 1999, IFSA has had in place an *Industry Code of Ethics and Conduct* supported by a number of industry standards and guidelines that are designed to assist members achieve industry best practice, and to enhance consumer confidence[10].

Rigorous industry codes and standards are, in IFSA's view, an important component of the overall regime applying to industry regulation. Reliance on codes and standards can build public trust and consumer confidence in the industry as well as exerting moral and business pressures on those sections of the industry that may otherwise be tempted to behave in an unprofessional way. IFSA has shown that it is able to alter member behaviour through standards and guidance notes[11].

The requirement for all IFSA members to conform to rigorous industry standards will support the use of principle based legislation by Government, and will promote market confidence and adherence to the principles of the legislation.

4.2 Formal Consultative Process

It is IFSA's view that future regulatory changes must be considered in the context of their capacity to deliver actual positive benefits to consumers. Reactive regulatory responses are only justified where there is a market failure, or a reasonable possibility of market failure and intervention can be shown to be the only effective way of remedying or preventing such market failure.

Good quality analysis should be a feature of policy development and decisions at all points of the process. As such, this requires input from all affected stakeholders so

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[10] The current IFSA Standards are:

- No1: Code of Ethics and Conduct
- No2: Equity Trusts
- No4: Ongoing Fee Measurement
- No5: Operational Capability
- No6: Fund Performance, calculation of returns
- No7: Use of IFSA logo
- No8: Scheme Pricing
- No9: Valuation of Scheme assets & liabilities
- No10: Promotional Statements
- No11: Genetic Testing Policy
- No12: ASIC fee template
- No13: Proxy Voting
- No14: Alternative forms of remuneration
- No15: Rebates & related payments

[11] See IFSA Standard No.13 Proxy Voting and IFSA/FPA Standard on Soft Dollars

that a considered approach to the issue becomes a vital ingredient to any new regulation.

Currently, the consultative arrangements with industry employed both by Government and the regulators operate in an 'ad hoc' fashion and lack any structure or arrangements for accountability. Our industry's discussions and lobbying efforts are not as effective as they could be simply because they can be dissipated amongst the various interested parties – other industry groups, regulators, Government officials, and members of Parliament. As with any area of endeavour, improvements can always be made and, we believe, a better system for consultation can be built.

As indicated in the introduction to this Headland Statement, "effective communication" is IFSA's primary tool in seeking to achieve a regulatory system that is effective, efficient, accountable, responsive, and that provides confidence and comfort to our customers.

To improve consultative arrangements we think that the existing policy and legislative delivery mechanisms need to be fine tuned or supplemented. Therefore, in addition to our recommendations for principles based legislation, the greater use of self regulatory codes, and closer attention being given to the costs of regulation, it is our recommendation that the Government endorse a formal consultative structure involving a 'gatekeeper' for proposed regulatory changes. For the purposes of the discussion we refer to the 'gatekeeper' as the Financial Services Committee (**FSC**) which would include representatives from each stakeholder group[12].

This, of course, raises a number of questions:

- Won't a formal consultative structure simply create **a new bureaucracy** for industry to deal with?
- Why not use one of the **existing consultative committees** established by Government?
- **What does a formal consultative structure look like and how does it operate**?

A new bureaucracy – existing Committees

Government has, from time to time, established various advisory committees drawn from business, consumer and professional groups, and industry associations to assist it in providing independent guidance on specific legislative proposals and reforms[13].

It may be appropriate for the role of an existing committee to be expanded or evolve to provide the functions envisaged for the FSC, or to simply establish the FSC as a permanent feature of the process of regulatory reform[14].

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12 Financial Services Industry, Government and Regulators.

13 Business Regulation Advisory Group (**BRAG**) - 1998; Financial Sector Advisory Council (**FSAC**) - 1998; Taskforce on Reducing the Regulatory Burden on Business – 2005; AML Ministerial Advisory Group – 2003.

14 A recent industry initiative was the establishment in 2004 of the Finance Industry Council of Australia Ltd. FICA represents Australian Bankers Association, Australian Finance Conference, Insurance Council of Australia, Australian Financial Markets Association and the Investment and Financial Services Association. It provides a common forum for its member

Formal consultative structure

The FSC should be a permanent consultative feature of the legislative and regulatory reform process. However, the FSC should only be an advisory body commenting on reform proposals in much the same way as a Parliamentary Scrutiny of Bills Committee, but with member representatives of Financial Services Industry, Government officials and Regulators. It is noted that reform proposals can take the form of draft legislation, regulations, legislative instruments[15] and, in some instances, policy papers and guidance notes.

Formal consultative arrangements should apply only to matters and issues having a broad impact on industry operations. They would not apply to individual relief applications. The FSC will, therefore, effectively have a role in pre-vetting legislative instruments as part of a formal consultation arrangement. It would, of course, still be open to regulators to make legislative instruments without the endorsement of the FSC. However, where such instruments are made without FSC endorsement they would, it is hoped, attract added Parliamentary scrutiny and be subject to possible disallowance[16].

The consultative steps outlined below recognise both the Government and the Regulators as prime movers amongst a number of stakeholders with an interest in a reform issue.

1. Regulatory reform issue brought to the attention of the FSC by the Regulator or by Department of Treasury, the Minister or the Parliamentary Secretary.

2. The Treasury or Regulator develops, for consideration and revision by the FSC, a draft of proposed:

- legislation / regulations
- standard
- guideline
- class order
- policy paper
- practice note

3. FSC decides priorities and delegates the reform issue to a sub-committee for regulatory development. Sub-committee members represent the views of their associations / affiliations in the development / comment.

4. FSC provides comment and any recommendations to the Regulator or Treasury.

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associations to address issues affecting financial services in Australia and fostering a competitive, free and efficient market for those services. It also provides a focus for the discussion of international issues affecting providers of financial services in Australia.

[15] See Legislative Instruments Act 2003 (Cth)

[16] This would not effect Part 3 of the Legislative Instruments Act 2003 – Consultation before making legislative instruments – but would identify it as not having been subject to FSA review.

5. Regulator or Treasury release proposal for public comment. Comment considered in the finalisation of the reform proposal.

6. FSC provides comment / endorsement of the final reform proposal.

7. Reform proposal passed / allowed / disallowed by the Parliament.

4.3 Analysis of costs and benefits

Proposed regulatory reforms to be considered by Government require "a regulation impact statement (**RIS**) to be prepared for all proposed new or amending legislation which directly affects business or which has a significant indirect effect on business or restricts competition"[17] .

While the RIS requirement has been in place since 1997[18], as an industry, we would like to see greater rigour in relation to RIS and have the requirement extended to a broader range of reform proposals impacting the financial services industry.

5. CONCLUSION

Good commercial practice is underpinned by good regulation. If the Australian financial services industry is to continue to grow, be innovative and internationally competitive, we must continue to strive for greater cooperation and more efficient regulation. This is not the responsibility of Government alone, but one that is shared by industry, regulators and Government.

A lot of effort, energy and resources have been used designing and implementing a regulatory regime that will assist the development of the financial services industry in Australia in the 21st century and, that will maximise the returns for all Australians. It is now time to fine-tune the legislative and regulatory regime that was put in place with the commencement of FSRA.

6. RECOMMENDATIONS

Recommendation 1 - Principle Based Legislation

IFSA recommends that every effort should be made to ensure that the drafting of legislation should be principles based.

[17] Legislation Handbook, Department of Prime Minister and Cabinet, Canberra, paragraph 2.9 – Impact of legislation on business.

[18] Statement by the Prime Minister, the Hon John Howard, MP, *More Time for Business*, 24 March 1997, AGPS Canberra pages 66 to 67.

Recommendation 2 - Industry Self Regulation

IFSA recommends that greater use and reliance be placed on Industry Codes of Practice as a regulatory tool. This should be done conjunction with principles based legislation.

Recommendation 3 – Formal consultative process

IFSA recommends that a formal consultative process be established for proposed Government legislation and regulations, and for standards, class orders, guidelines, policy statements and practice notes issued by regulators that have broad application to the financial services industry.

Recommendation 4 – Financial Services Committee

IFSA recommends that a Financial Services Committee be established on a permanent basis to consider draft regulatory reforms and provide to Parliament its comments and/or endorsement of regulatory proposals.

Recommendation 5 - Risk/Benefit Approach to Regulation

IFSA recommends that any future regulation of the financial services industry adopt a more rigorous and broader risk/benefit based approach to the financial services regulation.

ATTACHMENT B

NEWSPOLL SURVEY for IFSA
The Financial Fitness of a Nation

Looking forward to pay day?
Two thirds (65%) of people say that they budget well and are living normally in the week before pay day. 9% of people even say they are thinking about transferring the money they've not spent into a savings account.

		Age			Capital City	
	Total	18-34	35-49	50-64	Syd	Mel
Pulling your belt in and living on beans on toast	12%	14%	12%	9%	12%	9%
Living normally, the credit card provides instant access to cash	8%	5%	15%	5%	5%	13%
Living normally, you've budgeted well and you have enough to see you through	65%	62%	64%	71%	64%	69%
Thinking about transferring the money you've not spent into a savings account	9%	11%	6%	8%	10%	9%
Don't know	6%	7%	3%	7%	8%	5%

Question: During the week before payday, which one of the following best describes you?

The best place to put your savings.
When asked where they were most likely to put their money if they were saving for an event in five years time (i.e. having children, a wedding etc), 44% of people said they'd look to a high interest savings account and 28% of people opted for the regular bank account. 6% of people thought shares were a good option and 9% said they'd look to a Managed Fund. Worryingly 8% of people still thought the jam jar under the bed was a sensible option.

Those most likely to put their money in the 'jam jar' are those aged between 18-24, single people, those educated to secondary level only, and those with a household income of less than $30,000.

	Jam jar under the bed	Regular bank account	High interest bank account	Shares	Managed Fund
Total	8%	28%	44%	6%	9%
Women	10%	30%	46%	3%	9%
Men	7%	26%	42%	10%	9%
18-34 years	10%	25%	52%	5%	7%
35-49 years	8%	32%	37%	8%	10%
49-64 years	6%	28%	42%	7%	10%
Married	7%	29%	44%	6%	9%
Not Married	11%	28%	44%	7%	8%
Primary/Secondary level education	14%	35%	38%	6%	3%
College/Apprenticeship	10%	31%	41%	4%	10%

University Degree	1%	18%	53%	9%	12%
Less than $70,000	11%	35%	38%	2%	6%
$70,000 plus	6%	19%	45%	12%	14%

Question: If you were going to make regular savings for an event in five years time, in which of the following would you be most likely to save your money?

Savings Vs personal debt (not including any mortgage)

37% of Australians have more debt than savings. That number increases to 45% when looking at the 30-49 age bracket. Those with children also fair worse with 47% saying they are in debt beyond their levels of saving.

Levels of household income make little difference with 34% of those earning less than $70,000 a year, saying they have more debts than savings and 47% of those earning more than $70,000 saying the same thing.

Interestingly, the same number – 37% - of Australians say they have savings in excess of their personal debt. In this area, men fair better than women with 45% of men saying they are in this category and only 28% of women.

Having children also seems to put a strain on savings as 41% of those without children say they have levels of saving to cover their debts, but only 31% of those with children can say the same thing.

The factor that makes the biggest difference in whether or not people have more savings than debt is whether or not people have a financial adviser.

		Financial Adviser	
	Total	**Have**	**Do not have**
More debt than savings	37%	31%	**39%**
Equal debt and saving	22%	17%	24%
More saving than debt	37%	**50%**	31%
Don't know	5%	3%	6%

Question: Apart from your mortgage, would you say you have………..

Coming into money? What would you do if Aunt Agnes left you $2,000?

A majority of Australians seem to be quite sensible when it comes to a windfall.

40% of people said they'd put the money towards paying off their credit card or home loan and 22% said they'd put it into their superannuation or a managed fund.

One in five (20%) people said they'd treat themselves to a holiday and a significant minority (12%) said they'd keep it in their wallet – because you never know when you might need it.

Women feel they are more deserving of a holiday than men, with 23% of women going for the holiday option, compared to 18% of men. However men are more likely than women to hold the money in their wallets with 14% of men saying that's what they'd do with the money, compared to only 9% of women.

Those who'd look to invest the money in their superannuation or a managed fund (22%) were more likely to be aged between 18–34 years (24%) and 50-64 years (30%) than between 35-49 years (13%). They are also more likely to have a financial adviser (36% with a financial adviser compared to 16% of those who do not have a financial adviser).

What's a good investment?
Luck appears to be with 3% of Australians as they say that a day at the races is a better investment than a high interest savings account, their super or a managed fund.

The same number- 3% - believe that buying the latest designer clothes is the best investment for them.

	A day at the races	The latest designer clothes
Total	3%	3%
Women	3%	3%
Men	3%	2%
18-34 years	1%	6%
35-49 years	3%	0%
49-64 years	4%	2%

Question: Which one of the following do you think represents the best investment?

Others took a more sensible approach to investing with 31% saying a high interest savings account represents the best investment, 26% saying a managed fund and 33% saying superannuation.

Age played a significant role in how people see these difference types of vehicles, with older people favouring superannuation and younger people looking to the high interest savings account and managed funds.

	Total	Age 18-34	Age 35-49	Age 50-64
High interest savings account	31%	38%	27%	25%
Investing in a managed fund	26%	32%	29%	13%
Putting extra money into superannuation	33%	19%	38%	47%

Question: Which one of the following do you think represents the best investment?

Understanding super
43% of respondents do not know what their employers must put into their super fund. The correct figure is 9% of your salary. Only 57% of people gave the correct answer.

Women appear to be more 'in the dark' than men, as do those educated to secondary level only and those with a household income of less than $70,000 a year.

	Total	Male	Female	Highest Education Completed: Secon d-ary	Highest Education Completed: College	Highest Education Completed: University	Household Income: <$70,000	Household Income: $70,000>
Five percent	17%	13%	21%	23%	15%	14%	21%	13%
Nine percent	57%	65%	49%	40%	58%	72%	46%	72%
Fifteen percent	11%	10%	11%	9%	14%	8%	12%	9%
Nineteen percent	4%	8%	13%	7%	3%	3%	7%	3%
Don't know	11%	8%	13%	21%	9%	3%	12%	3%

Question: Thinking about super. Which one of the following do you think is the minimum percentage of salary an employer must put into their employees' superannuation?

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When asked what factors play the greatest role in influencing what someone might get from their super when they retire, 15% say it is the amount of money they put into their super, 6% say it depends on how well the share market performs, 7% say it depends on the fees charged by the fund and 65% (correctly) say it depends on all these factors equally.

Those with a financial adviser are significantly more likely to understand that it is all of the factors listed which equally affect the money they receive – 74% with an adviser compared to 62% of those without an adviser.

Super status

Only 23% of Australians are putting additional money into their super – others say that they would consider making extra contributions but are paying the mortgage off first (17%) or that they have enough to worry about paying the bills without having to think about paying extra into their super (22%).

Age and marital status are significant factors when looking at those who do salary sacrifice additional contributions to their super.

	Additional contributions into Superannuation
Total	23%
18-34	10%
34-49	30%
50-64	33%
Married	29%
Not Married	14%
Less than $70,000	21%
$70,000 plus	27%
Have a financial adviser	39%
Do not have a financial adviser	17%

Which one of these best describes your own situation with regards to superannuation?

A helping hand?

67% of Australian's believe that a qualified financial planner is the best person to help them with their finances, 13% would look to a family member, 11% a bank, 2% friends and only 1% of people would look to an employer.

60% of Australian's who don't currently see a financial adviser believe that a qualified financial planner is the best person to help them with their finances.

Income and gender are significant factors in determining who people would seek financial help from:

				Household Income		**Financial Adviser**	
	Total	**Male**	**Female**	**<$70,000**	**$70,000>**	**Have**	**Don't have**
Family member	13%	13%	13%	14%	11%	6%	16%
Bank	11%	8%	13%	13%	7%	5%	13%
Qualified Financial Planner	67%	68%	67%	67%	76%	86%	60%

Question: Which of the following do you think is best placed to help you manage your finances?

Australian Financial Goals
Three quarters of Australians (74%) say their financial goal is to be able to retire comfortably at an age of their choosing.

Having a comfortable retirement is also more likely to be the financial goal of those currently working full time (80%), those who are educated to university level (86%), those earning over $70,000 (86%) and those with a financial adviser (84%). It is much less likely to be a financial goal of those between 18-34 years (66%), those not currently working (57%) and those earning less than $30,000 (48%).

18% of those with a household income of less than $70,000, say winning the lottery is their main financial goal. This compares to 15% of the total population.

3% of men said their financial goal was to buy a flat screen plasma TV – only 1% of women said the same thing.

Questions developed by IFSA and Mercer

Released: 27/07/06

ATTACHMENT C

Investment Trends/IFSA - Self Managed Super Funds (SMSF) Report: SMSF Trends (February 2006)

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Investment Trends

Investment Trends/IFSA Self Managed Super Funds (SMSF) Report:

SMSF Trends

February 2006

IFSA

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1 Executive summary

IFSA commissioned Investment Trends to produce this report examining the self managed super fund (SMSF) market. The report is based on two detailed quantitative surveys totalling 1,189 SMSF members conducted by Investment Trends.

Self managed super funds are now the second largest category of superannuation behind retail super. As of June 2005, SMSFs held $166 billion in super assets, up 24% in the preceding 12 months (source: APRA). Assets held in SMSFs are growing faster in percentage terms than any other superannuation category besides industry funds. Growth in SMSF assets over recent years has been fuelled by an increased establishment rate, new member contributions and strong asset appreciation. The SMSF establishment rate spiked by around 50% over 2002-3, in direct response to the prolonged bear market of 2000-2. This occurred before the advent of super choice, which may facilitate a comparable or even larger shift of funds when we next have a long bear market.

Control

SMSF investors cite an average of 3.3 main reasons each for setting up their fund. Whilst historically there has been a belief that SMSF growth was cost driven, we note that even among these 3.3 reasons, only one in four people (24%) cite saving money on fees as an important driver. There are four distinct though overlapping motivational segments within the SMSF market. These groups are driven by:

- Control: By far the most popular reason given for setting up a self managed super fund is investors' desire to exercise more control over their super (55%).
- Poor performance (36%) from existing super funds often drawing attention to fund charges (20%)
- Accountant's suggestion: (33%)
- Financial planners suggestion (29%)

We note that both planners and accountants have fallen as instigators over recent years, as more investors themselves initiate the establishment of an SMSF.

Role of advice

Accountants are the dominant source of advice on SMSFs. As of December 2004, 62% of SMSFs say they currently paid an accountant/tax agent/auditor) to help with their funds. Around 28% of SMSFs said they paid a financial planner.

It has been widely noted that there is a high level of under-insurance in Australia, with many people having inadequate or even no life cover. We note that those SMSF members using a financial planner or bank based adviser had a considerably higher incidence of life insurance through the SMSF than those not using a planner (32% and 35% respectively, versus the 24% average for all SMSFs).

Scale and drivers

There a significant minority of small SMSFs, with 28% having total balances under $100,000. Compared to large (>$250k funds), small SMSFs were 63% more likely to say they set up their fund based on advice from a friend who had one (18% versus 11%), almost three times as likely to highlight a job change as a driver (22% versus 8%), 50% more likely to cite consolidation of multiple super funds as a driver (29% versus 19%) and only half as likely to be set up in response to recommendation by an accountant (21% versus 41%).

Costs

There has been extensive industry discussion on what represents an appropriate minimum balance for SMSFs. Clearly this is linked to how much SMSF investors are actually spending to run their fund.

The costs associated with running an SMSF vary greatly depending on the size of the SMSF, the range and types of advisers used, and the types of assets into which funds are invested. Whilst average cost figures can obscure this variation, it was felt that the ongoing industry discussion required more information on the typical level of costs involved. Therefore, based on extensive survey data and modelling, Investment Trends estimates the average annual amount spent per SMSF on running their fund at $3,500.

This figure includes the cost of accountancy, investment and financial planning advice, where used, and an assumed 2% management expense ratio (MER) on managed fund investments, but excludes transaction costs, which are typically not included in calculating costs for other super funds.

The average figure reflects the fact that only a subset of SMSFs seek investment advice relating to their fund. Those using a financial planner or accountant for investment or additional taxation advice often have higher average SMSF costs, reflecting the higher than average level of services they receive.

We note that SMSF costs tend to increase only slightly as fund size rises, such that the average cost of the SMSF structure in percentage terms declines as assets increase.

Investment vehicles

Shares and property are the dominant asset classes for SMSFs:

- 89% of SMSFs hold shares. The average share portfolio among those doing so is $180,000, and shares account for 33% of assets excluding listed property trusts (7%) and listed investment companies (2%)
- 60% of SMSFs hold property of some kind (residential, commercial or listed property trust). In total, 31% of SMSF assets are in property.

- 58% of which have managed fund investments, with an average holding of $120k. Managed funds account for around 15% of SMSF assets.

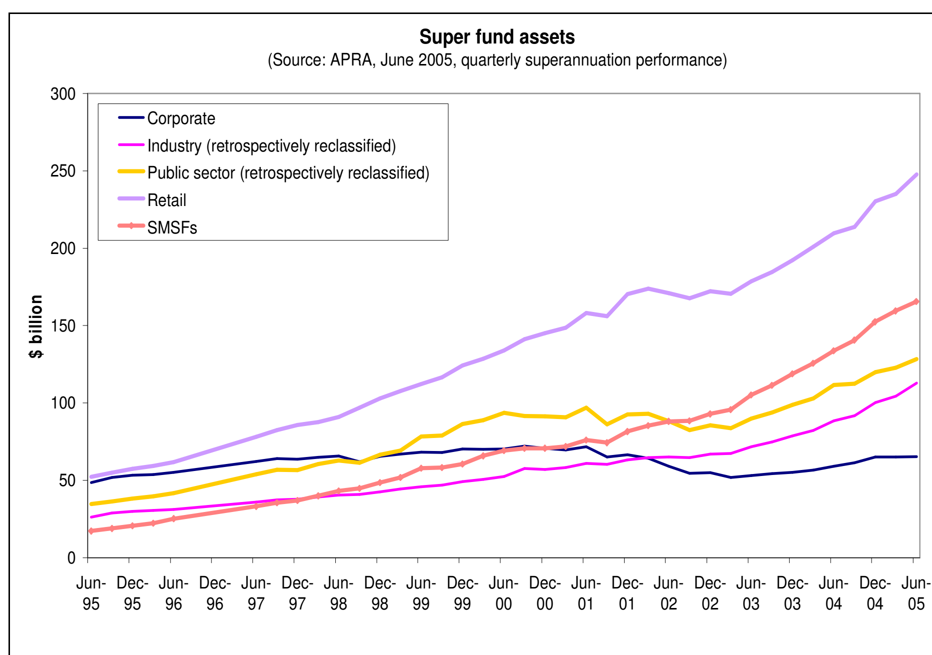
Managed funds are an important asset class within SMSFs. Some 78% of SMSFs say they are willing to invest in managed funds in future. Only half (48%) of those SMSFs planning to invest in basic managed funds say they would use a planner or bank based adviser to do so, rising to 57% for more complex managed investments such as private equity funds.

2 Background: Size and growth of the SMSF market

Self managed super funds are now the second largest category of superannuation, and grew 24% in the last year

Self managed superannuation funds (SMSFs) have become an increasingly significant part of the Australian superannuation landscape over the last five years. They are now the second largest segment of the superannuation market behind retail super. As of June 2005, around 300,000 SMSFs held $166 billion in super assets, up 24% in the preceding 12 months (Source: APRA). To put this in perspective, relative to retail super SMSFs had one twenty-fifth the members, but two thirds (67%) of the same level of assets.

IFSA has commissioned Investment Trends to produce this report examining the SMSF market, drivers of growth to date, asset allocation, the role of advisers and the role of managed funds within SMSFs. The report is based on two detailed quantitative surveys totalling 1,189 SMSF members conducted by Investment Trends in December 2004 and October 2005. The report will be updated where relevant with December 2005 data early next year.



Growth in SMSF assets over recent years has been fuelled by an increased establishment rate, new member contributions and strong asset appreciation

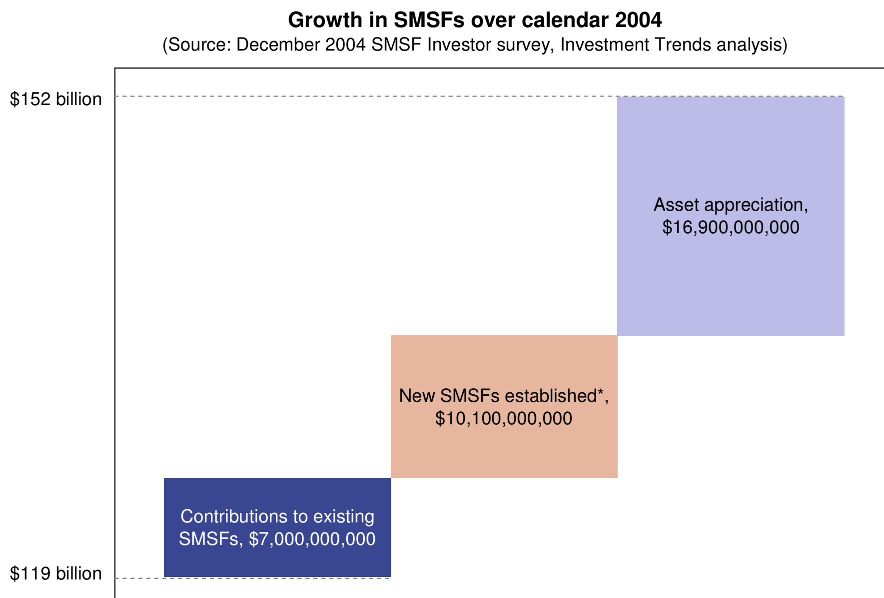
Assets held in SMSFs are growing faster in percentage terms than any other super category besides industry funds. As we will see below, growth has been fuelled by an increased establishment rate over 2002-2003, as well as strong asset appreciation in core investment classes of property and shares. For example, between December 2003 and December 2004, SMSF assets increased by $34 billion (28%) from $119 billion to $153 billion. Our analysis suggests that around 29% of this increase was as a result of new SMSFs established during this period, another 20% from new member contributions to existing funds, with the remaining 51% coming from asset appreciation.

	December 03 to December 04	
Contributions to existing SMSFs (1)	$7,000,000,000	21%
New SMSFs established (2)	$10,000,000,000	29%
Asset appreciation	$17,000,000,000	50%
Total increase in SMSF assets	$34,000,000,000	100%

Notes:

(1) Analysis based on survey of 570 SMSF members conducted for Investment Trends' December 2004 SMSF Investor Report

(2) Assumes 2,800 new funds per month over 2004, estimated average initial balance (all members) at $300,000. First figure based on ATO comments in the media, second figure based on Investment Trends analysis of above survey data for funds less than 2 years old.



3 Who is using SMSFs?

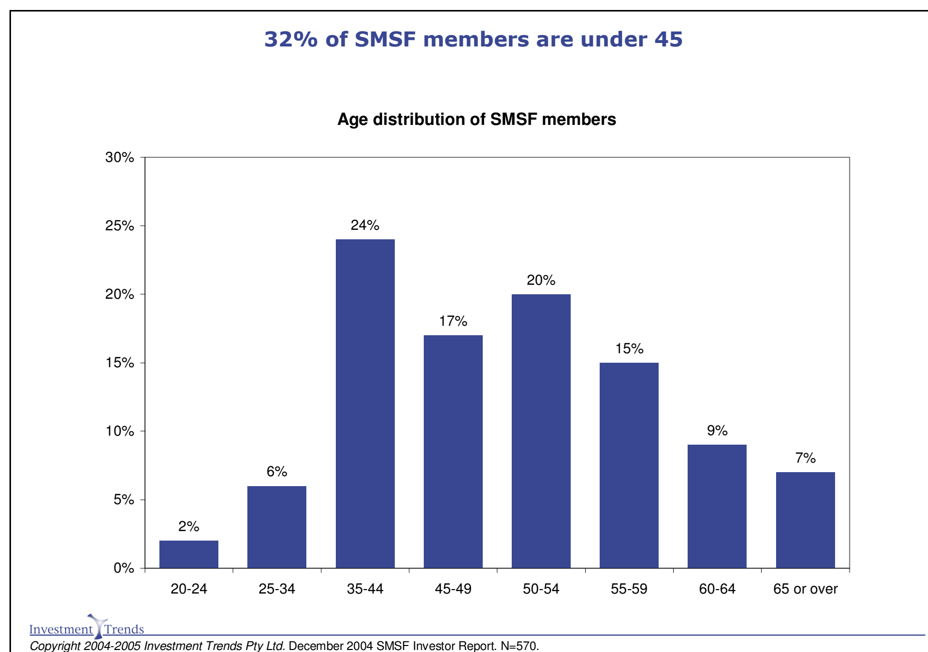
The SMSF market is more diverse than commonly imagined

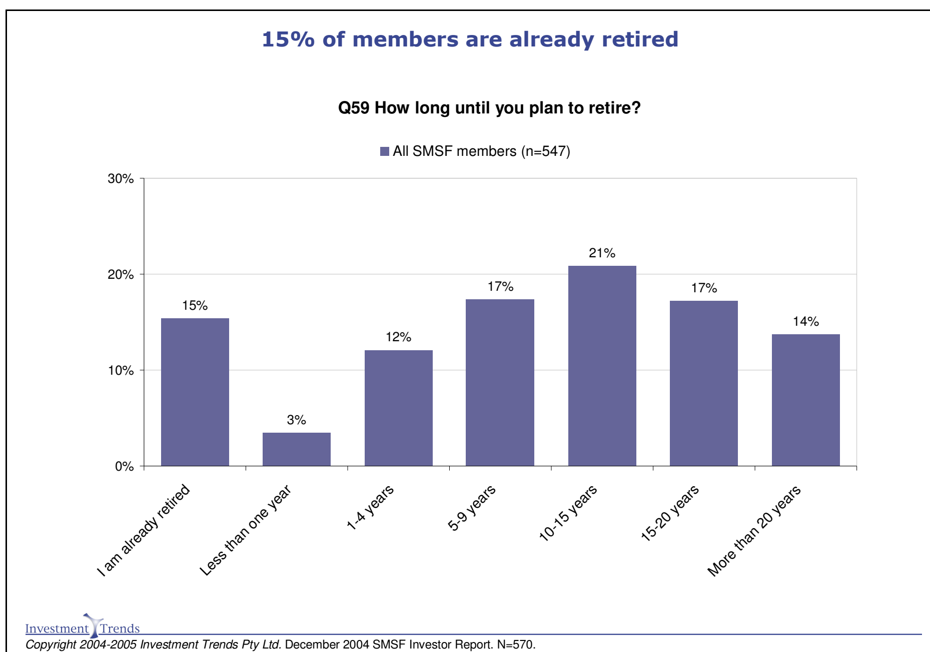
Consistent with their high average superannuation balances, SMSF investors are an older, wealthier subset of the population.

- 28% of SMSF members are over 55
- 15% are already retired
- Those still working are, on average, 8 years away from retirement

Beyond these basic similarities, SMSFs are no longer a homogenous market, with a range of occupations and backgrounds now represented:

- 60% of SMSF investors are male and 40% are female
- 38% of working SMSF investors describe themselves as business owners/self employed. Note though that the proportion of SMSFs with a self-employed member is likely to be higher, since SMSFs can have up to 4 members each
- Another 6% are professionals (accountants, lawyers, doctors etc) and another 8% are managers.
- Personal income is high, 29% earn more than $80,000 per annum
- Disposable income is even higher, as 55% own their own home outright




15% of members are already retired
Q59 How long until you plan to retire?
All SMSF members (n=547)
30%
20%
10%
0%
15%
3%
12%
17%
21%
17%
14%
I am already retired
Less than one year
1-4 years
5-9 years
10-15 years
15-20 years
More than 20 years
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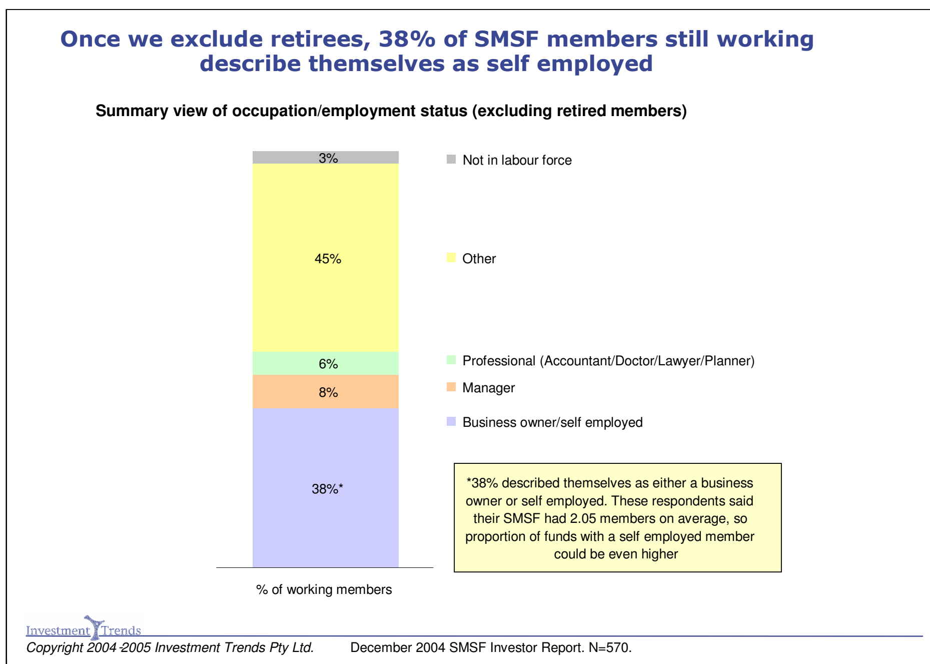
Once we exclude retirees, 38% of SMSF members still working describe themselves as self employed
Summary view of occupation/employment status (excluding retired members)
3%
45%
6%
8%
38%*
Not in labour force
Other
Professional (Accountant/Doctor/Lawyer/Planner)
Manager
Business owner/self employed
*38% described themselves as either a business owner or self employed. These respondents said their SMSF had 2.05 members on average, so proportion of funds with a self employed member could be even higher
% of working members
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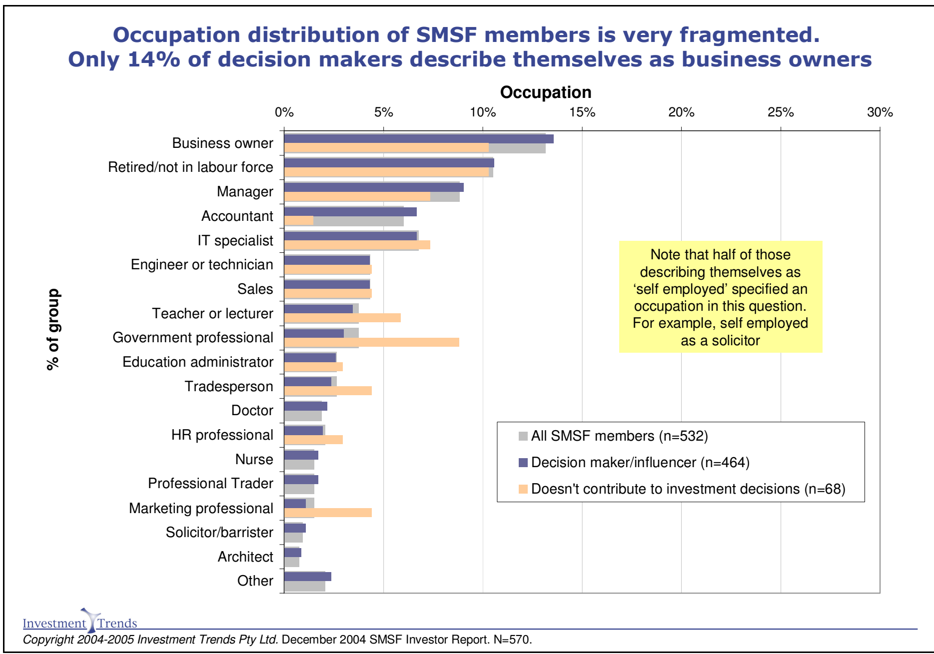
Occupation distribution of SMSF members is very fragmented.
Only 14% of decision makers describe themselves as business owners
Occupation
% of group
0%
5%
10%
15%
20%
25%
30%
Business owner
Retired/not in labour force
Manager
Accountant
IT specialist
Engineer or technician
Sales
Teacher or lecturer
Government professional
Education administrator
Tradesperson
Doctor
HR professional
Nurse
Professional Trader
Marketing professional
Solicitor/barrister
Architect
Other
Note that half of those describing themselves as 'self employed' specified an occupation in this question. For example, self employed as a solicitor
All SMSF members (n=532)
Decision maker/influencer (n=464)
Doesn't contribute to investment decisions (n=68)
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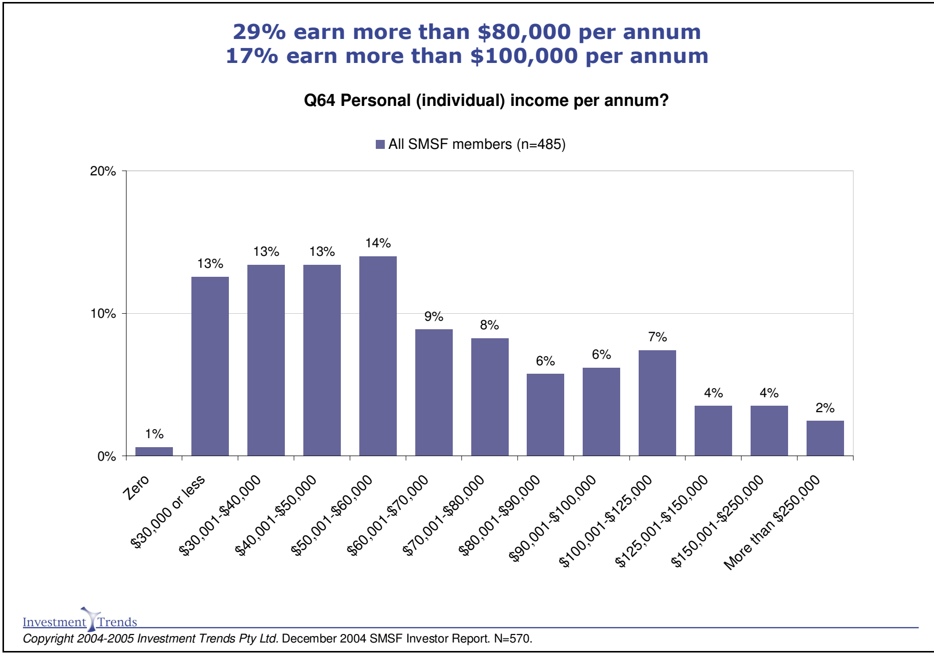
29% earn more than $80,000 per annum
17% earn more than $100,000 per annum
Q64 Personal (individual) income per annum?
All SMSF members (n=485)
20%
10%
0%
1%
13%
13%
13%
14%
9%
8%
6%
6%
7%
4%
4%
2%
Zero
$30,000 or less
$30,001-$40,000
$40,001-$50,000
$50,001-$60,000
$60,001-$70,000
$70,001-$80,000
$80,001-$90,000
$90,001-$100,000
$100,001-$125,000
$125,001-$150,000
$150,001-$250,000
More than $250,000
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4 Drivers of SMSF growth

4.1 Why people set up SMSFs

Control is the dominant driver of SMSF establishment

SMSF investors cite an average of 3.3 main reasons each for setting up their fund. Whilst historically there has been a belief that SMSF growth was cost driven, we note that even among these 3.3 reasons, only one in four people (24%) cite saving money on fees as an important driver. This is significant in understanding the impact of SMSFs on the broader funds management industry, and helps to explain both the high willingness to use managed funds among SMSFs (58% do so) and the high proportion of low balance funds (28% are under $100,000 in total assets).

Although people can have any number and combination of reasons for establishing a SMSF, statistical analysis of our survey data reveals that there are 4 main groupings of reasons that usually go together. That is, there are four main motivational segments within the SMSF market. These groups are driven by:

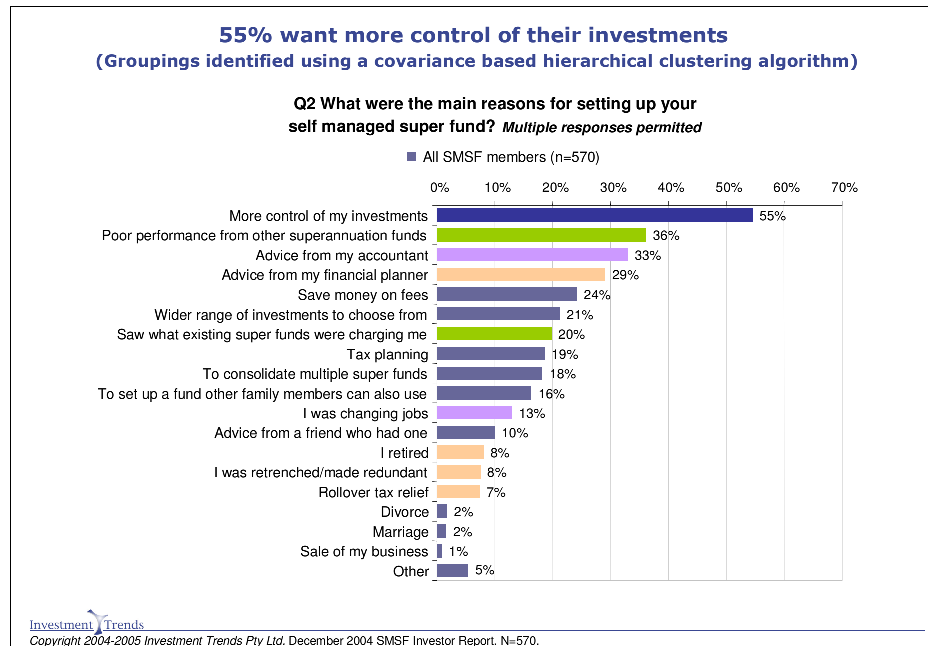
- **1. Control**: By far the most popular reason given for setting up a self managed super fund is investors' desire to exercise more control over their super (55%). Control is even more prominent in recently established (60%) and larger balance SMSFs (72%). This is the largest group, and has several subgroups of other motivations that are often associated with this general desire for control:
  - Control and saving money on fees
  - Control and demand for a wider range of investments
  - Control and a desire to consolidate multiple super accounts
  - Control, friends' advice and perceived tax benefits
  - Control and a desire to include family members in the SMSF

Beyond the control group, there were three others of roughly equal size:

- **2. Poor performance drawing attention to fund charges:** Those people establishing an SMSF because of poor performance from their existing super fund (36%) were very likely say "I saw what my existing fund was charging me". That is, awareness of fees usually flowed from, and was associated with, poor investment performance. Put another way, clients disillusioned with returns were more likely to feel that their existing super fund was not performing well, regardless of whether this reflected underperformance or simply a drop in equity markets. As a result of this reassessment, many felt they were being charged too much by their existing super provider and opted to establish a SMSF instead.

- **3. Accountant's suggestion**: 33% cited advice from their accountant as a key reason for establishing their fund. Those citing accountants' advice as a driver were also more likely to highlight changing jobs as a reason.

- **4. Financial planners suggestion:** 29% cited advice from their planner as a driver for establishment. This was commonly associated with retirement related issues "I retired/rollover tax relief" as well as redundancy payments: "I was retrenched/made redundant."



4.2 Size based variations

Small SMSFs more likely to be set up in response to a friend's recommendation

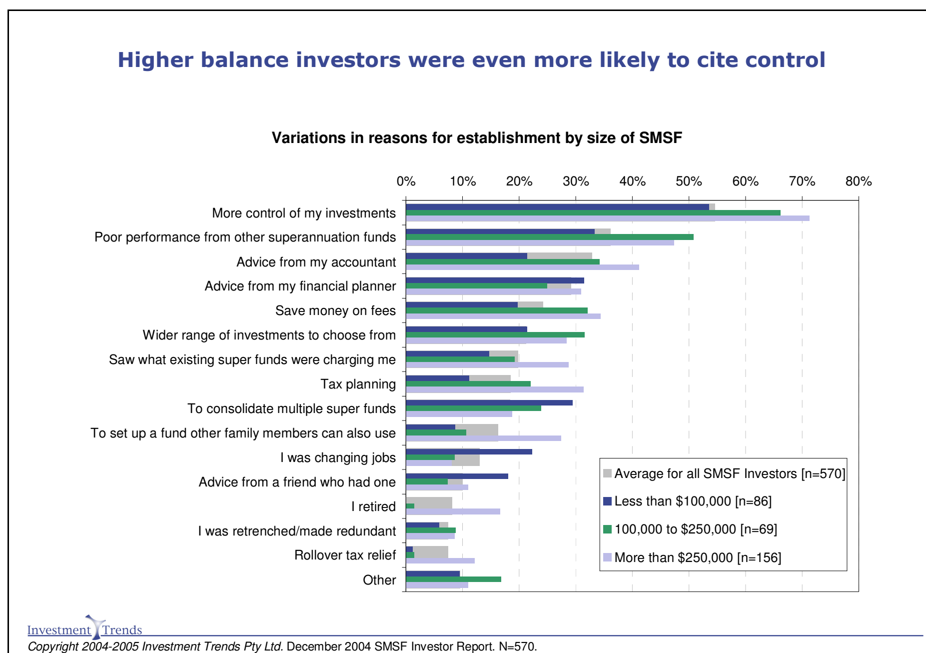
One concern often cited by regulators is the number of low balance funds, given that below a certain level of assets the fixed costs of establishing and running an SMSF may make it an expensive structure in percentage of asset terms. It is therefore important to understand why these lower balance funds have been set up.

We found that, relative to the average, lower balance SMSFs (<$100k) tended to cite fewer reasons for setting up their fund. That is, their motivations were simpler than for higher balance funds. In spite of this lower average number of reasons cited, certain motivators were still more/less prominent among this group. Compared to large (>$250k funds), small SMSFs were:

- 63% more likely to say they set up their fund based on advice from a friend who had one (18% versus 11%)
- almost three times as likely to highlight a job change as a driver (22% versus 8%)

- 50% more likely to cite consolidation of multiple super funds as a driver (29% versus 19%)
- Half as likely to be set up in response to recommendation by an accountant (21% versus 41%)

A similar proportion of small SMSFs as large (around 32% each) said that advice from a financial planner was a motivator.

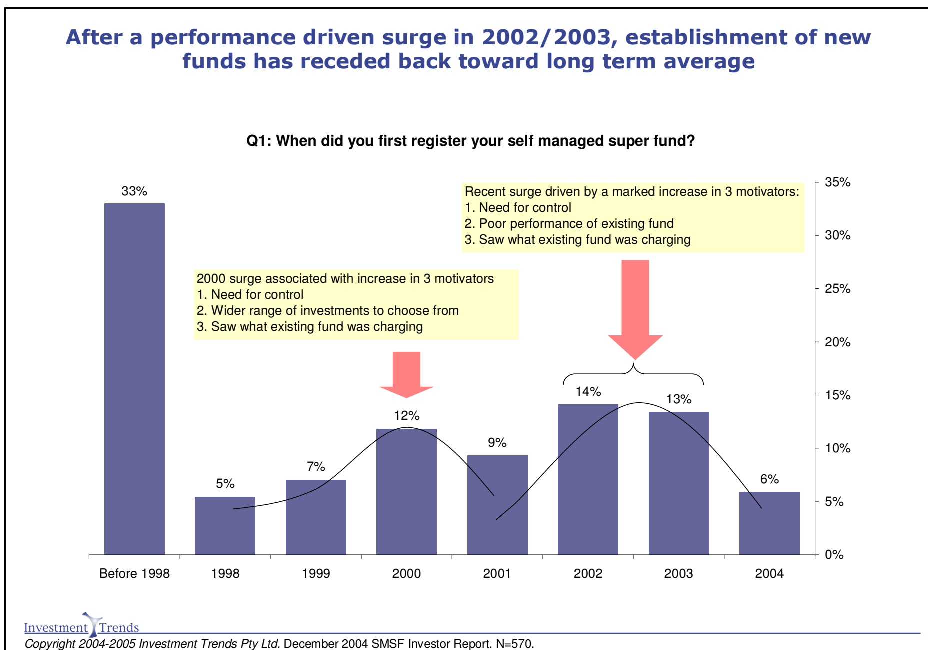


4.3 Trends in reasons for establishment over time

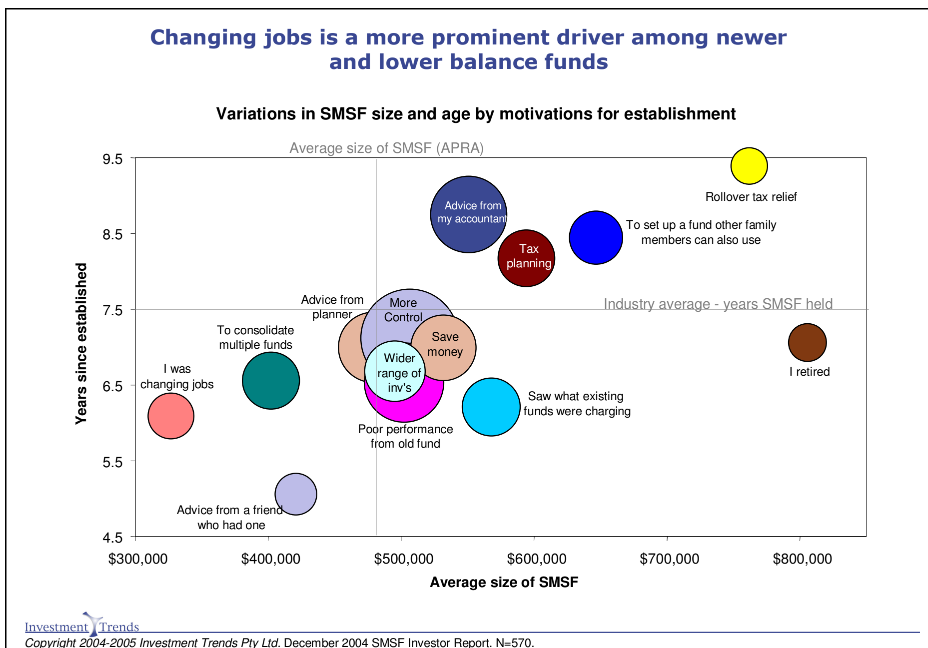
The SMSF establishment rate spikes when existing super funds perform poorly

Analysis of variations in reasons for establishment over time reveals a 50% spike in the second motivational group (poor performance and noticed what they were being charged) over 2002-2003. This followed the prolonged bear equities market between 2000 and 2002.

This spike has significant implications particularly as it predated the introduction of super choice legislation. It is possible that in a post choice environment, where employees have more flexibility with regards to their super, we may see an even larger spike in the establishment rate when we next have a prolonged bear market.



The chart below summarises much of the preceding information. It reflects variations in average SMSF size and age (years since establishment) depending on the reasons people gave for establishing their SMSF. Items higher on the chart reflect reasons that were more prominent in the past, while those further to the right are more likely to be drivers for larger funds. The size of the circles reflects how many people choose this option.



As shown above, advice from a friend is a more common reason among newer and lower balance funds, while rollover tax relief was a more prominent driver in the past, and many funds set up on this basis are quite large.

4.4 Will current members retain their SMSF?

Reflecting their control orientation, few SMSF clients plan to leave this structure on retirement

There has been much discussion in the media about the appropriateness of SMSFs given their complexity and the serious implications of compliance breaches. However, our research suggests that in the absence of any major catalyst for changing, most current SMSF members are unlikely to change out of the structure in the short term.

Most SMSF members who have considered the issue intend to continue with their SMSF on retirement and pay their pension out of the fund. Among those still working:

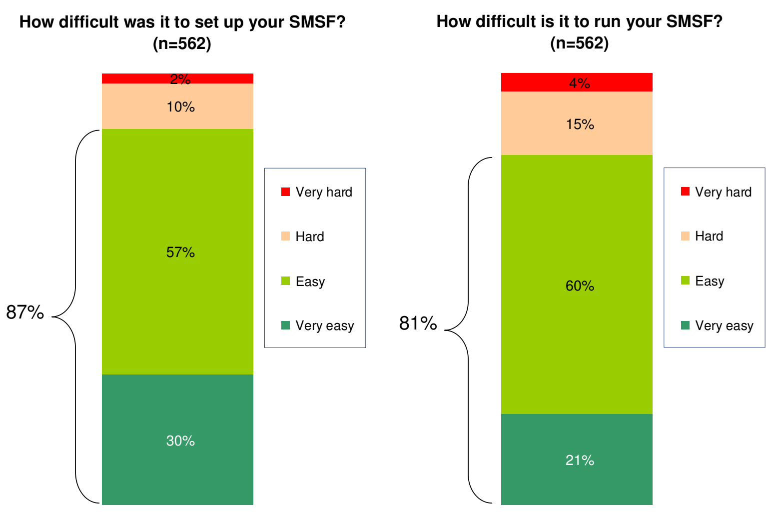
- 51% plan to keep their SMSF and pay their pension from it on retirement
- Only 6% plan to close their SMSF on retirement
- 43% haven't considered this issue yet

Most members *perceive* it to be easy to manage their SMSF

We can explain this preference to retain an SMSF when we understand that most members consider setting up and running an SMSF to be fairly straight forward:

- 87% found it easy to set up their SMSF
- 81% find it easy to run their SMSF
- Eight out of 10 believe they match or exceed the performance of other super funds
- Only 4% felt that their SMSF was difficult to set up
- Only 4% felt that their SMSF had performed worse than other super funds

We note that these statistics reflect people's perceptions and do not necessarily indicate what proportion are compliant with the relevant legislative and regulatory requirements.


Most members have found both establishing and running their SMSF to be relatively easy
How difficult was it to set up your SMSF? (n=562)
How difficult is it to run your SMSF? (n=562)
2%
10%
57%
30%
87%
4%
15%
60%
21%
81%
Very hard
Hard
Easy
Very easy
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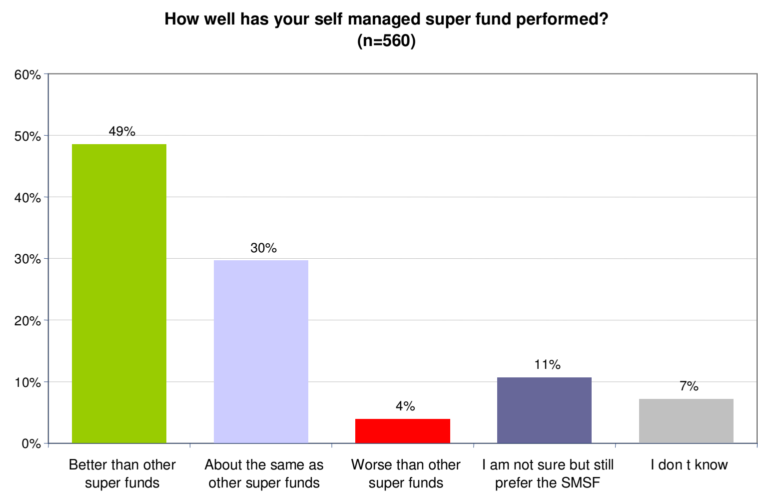
Only 4% of SMSF members believe their fund has underperformed other super funds
How well has your self managed super fund performed? (n=560)
60%
50%
40%
30%
20%
10%
0%
49%
30%
4%
11%
7%
Better than other super funds
About the same as other super funds
Worse than other super funds
I am not sure but still prefer the SMSF
I don t know
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5 Role of advisers in SMSFs

The following chapter examines investor feedback on the role of various advisers in relation to SMSFs. We note that today the lines are somewhat blurred in the adviser environment, with some accountants becoming qualified financial planners and FSR resulting in little real difference between planners and bank based advisers.

5.1 Advisers as instigators of SMSFs

Traditionally most SMSFs were initially established at the suggestion of a financial adviser (planner or accountant). However there have been two significant changes in the role of advisers as drivers of SMSF establishment over the last few years.

Accountants are decreasing as instigators of SMSF establishment

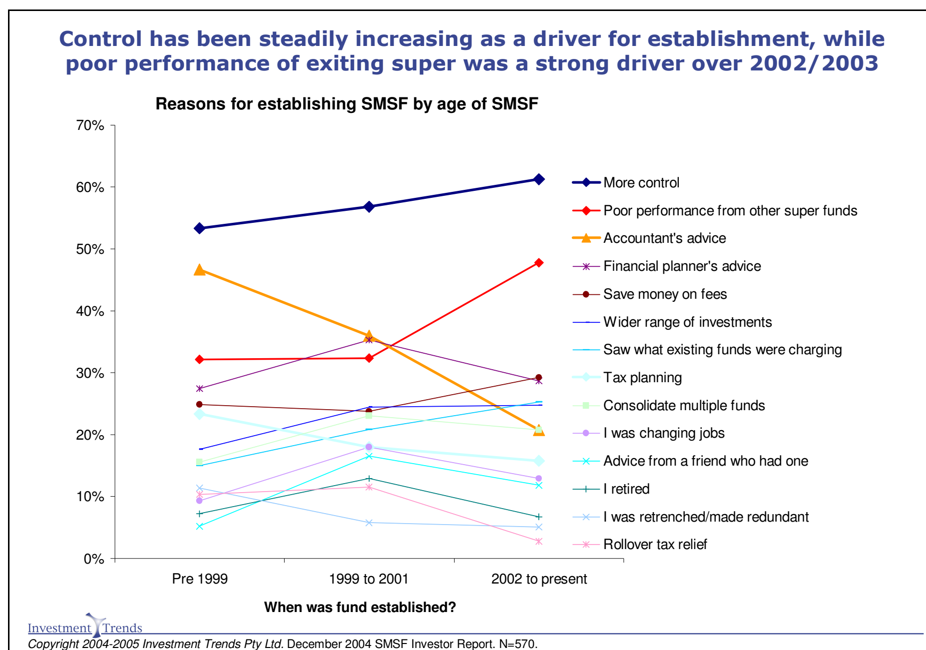
Those who established their SMSFs since 2002 are more likely to say they did so in response to advice from a planner than from an accountant (27% versus 19%). This reflects an ongoing decline in the role of accountants as instigators of SMSFs, in line with increased regulatory scrutiny of accountants advice in this area. Among SMSFs set up before 1999, half (46%) say advice from their accountant was a major reason for doing so. This figure has fallen to 19% for SMSFs established since 2002.

We note that these figures relate only to the role of accountants as **instigators** only, with the majority of SMSFs still being set up with the **assistance** of an accountant.

Advisers collectively have fallen as instigators, as more investors themselves initiate the establishment of an SMSF

While planners have overtaken accountants as instigators since 2002, we note that the number of SMSFs citing planners as instigators also fell between 2002 and the present.

This reflects a broader trend in the market, with SMSFs increasingly being established at the behest of investors, rather than at an adviser's suggestion.

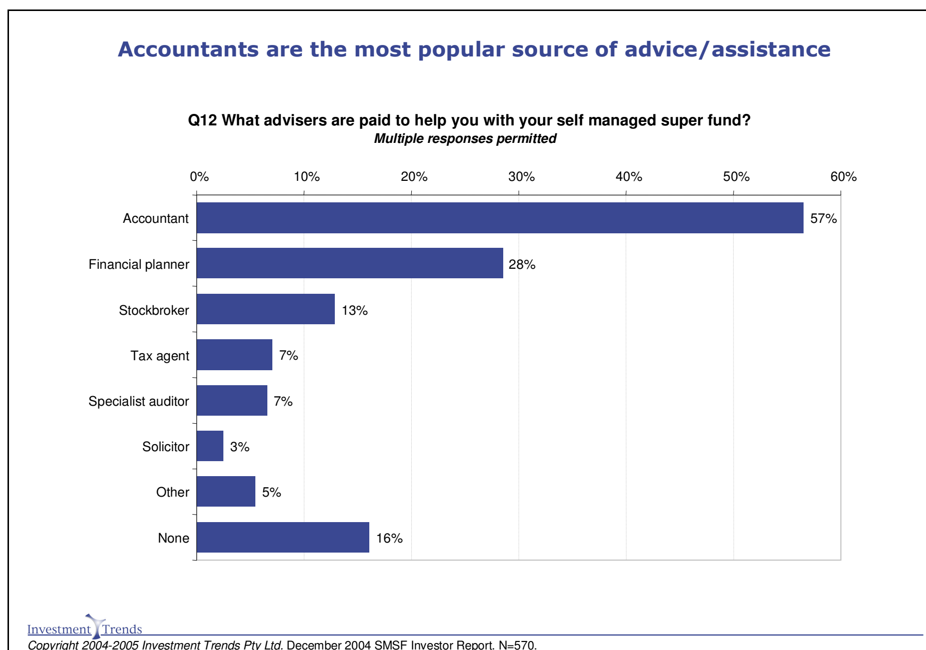


This trend may well continue, with a higher overall number of SMSFs leading to more networking effects (where investors know someone who has an SMSF), and with many investor and mainstream publications now having dedicated SMSF sections and articles on the subject.

5.2 Role of advisers in the ongoing management of SMSFs

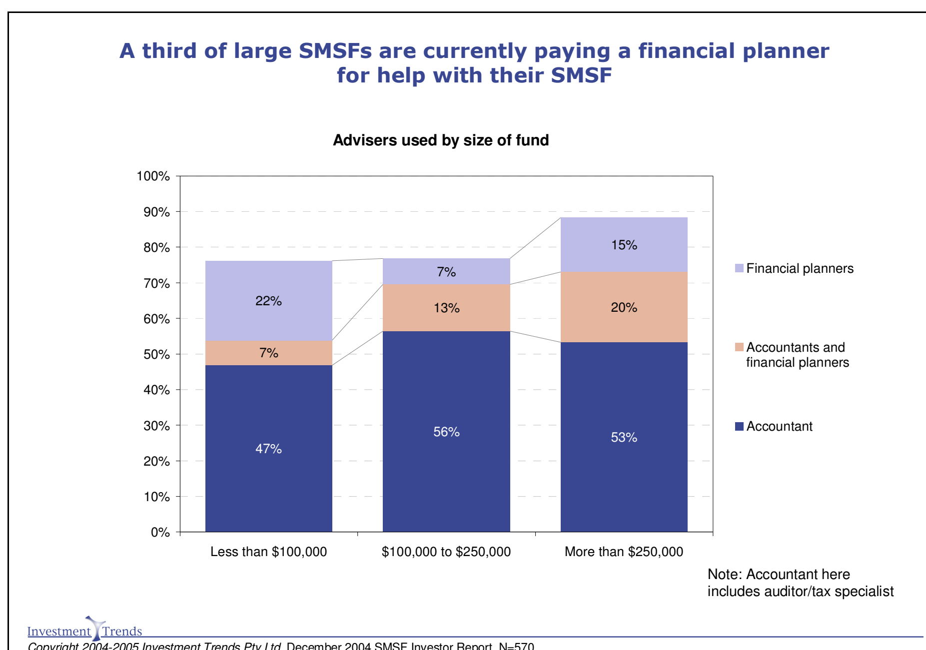
Accountants are the dominant source of advice on SMSFs

Accountants are the most widely used advisers among SMSFs, with 57% saying in the December 2004 survey that they were currently using an accountant to help with their SMSFs. Adding in tax agents and auditors raised this figure to 62% (after removing overlaps).

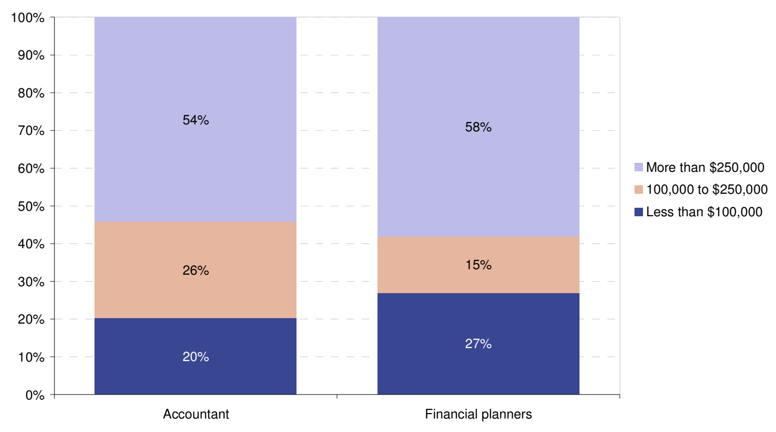


Around 28% of SMSFs said they paid a financial planner.

Four out of five (79%) of funds reported using some form of accountant or a financial planner and there were some overlaps between these advisers, with 11% using both.



We note that 47% of small SMSFs say they use an accountant, with 29% using a planner.


58% of SMSFs using a financial planner were over $250,000
Size of SMSFs advised, by type of adviser
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
54%
26%
20%
58%
15%
27%
Accountant
Financial planners
More than $250,000
100,000 to $250,000
Less than $100,000
Investment Trends
Copyright 2004-2005 Investment Trends Pty Ltd. December 2004 SMSF Investor Report. N=570.

6 Costs involved in running an SMSF

There has been much discussion in the industry about the appropriateness of SMSFs for different groups, and about the minimum balance which is necessary for SMSFs to be a cost-effective form of superannuation. Clearly one of the key dimensions of this debate is the cost involved in running a SMSF, and how these costs compare to alternative forms of superannuation.

6.1 Issues relating to costs

Several concerns are commonly raised in relation to the cost of SMSFs:

1) **A relatively high level of fixed cost make them inappropriate below certain superannuation balances**: There are certain fixed costs involved in maintaining a SMSF which need to be met regardless of the balance of the SMSF:
    a. ATO supervisory levy (annual return lodgement fee)
    b. The cost of the associated audit
    c. There will usually some professional assistance required to meet other compliance obligations, such as preparing accounts, tax returns and members' statements

2) **Potential for double layering of cost**: Another common concern is that there can potentially be two layers of costs involved where SMSFs utilise managed investments. Where other super funds have a single management fee, problems can arise where SMSFs pay this management fee and additionally pay the costs involved in running an SMSF.

3) **Lack of advice on appropriateness**: The above concerns are often emphasised in light of the fact that SMSFs can be and often are set up without associated investment advice, and so in many cases those assisting in establishment fall outside ASIC Policy Statement 146 requirements including 'know your client' rules.

6.2 Average SMSF cost and assumptions approach to calculating this figure

Clearly the level of fees involved is pivotal to any discussion of the SMSF market. To produce quantitative data to inform this industry discussion, in October 2005 Investment Trends surveyed 619 SMSF members in detail on how much they pay for their fund, and how much is paid to different types of advisers where they are used. This data on payments of which SMSF members are aware was then combined with earlier information from our December 2004 survey on the types of investments held (particularly the level of investment in managed funds within SMSFs). All of this data was modelled to produce estimates on the average amount actually spent per annum in running a SMSF.

Based on this survey data and modelling, we estimate the average annual amount spent per SMSF on running their fund at $3,500 as of December 2004.

In evaluating this figure, it is important to be aware of the inclusions, exclusions and assumptions used in the calculations:

- This figure includes fees for advice from accountants, planners, solicitors and other advisers where used.
- It assumes a 2% management expense ratio (MER) on managed fund investments held within SMSFs. It is assumed that managed fund trailing payments to advisers will come from within this 2%. In light of this, SMSF investors were asked to indicate how much was paid to financial planners excluding product commissions (where investor awareness is sometimes low).
- It excludes brokerage on share trades and any property acquisition, management or transaction costs. These costs were excluded to allow comparison with other super funds on a like for like basis, since such transaction and property management costs are usually taken out before performance figures are reported, and before management expense ratios applied on other super funds. We estimate that the average annual cost of property management expenses will be approximately $1,400 per annum per SMSF, with management/carrying costs estimated at 1.2% of property value.
- It includes up front product commissions paid on investments in managed funds. Product commissions were estimated using a combination of consumer perceptions and modelling based on managed funds transactions and awareness of up front fees.
- This figure does not include setup costs, as the effect of setup costs depends on the length of time for which the fund is operated. We have calculated the average setup cost for different groups and if these are amortised on a straight line basis over an assumed 20 year life of the fund, they would typically add $50-$65 per year.
- This figure does not include cost of investment related information such as newspaper and investment magazine subscriptions. We feel that most SMSF investors who purchase such decision-support material would tend to do so

regardless of whether they had an SMSF. Also, we contend that it is unlikely they would claim the cost of such purchases subscriptions against their SMSF for tax purposes, since in most cases it would be more tax-efficient for them to claim these deductions against their personal income.

- We note that figures on cost of professional advice on accountants are based on investor perceptions collected through the survey, and it is possible that some investors may be estimating these figures rather than quoting precise figures.

6.3 Variations in cost

Our calculations indicate that average SMSF costs increase with fund size, but that this increase is not proportional to the increase in fund size. Thus the average cost of the SMSF structure tends to decline in percentage terms as assets increase:

Fund size	Average amount spent per annum	Amount spent as a % of fund assets at this fund size
$175,000	$1,900	1.1%
$470,000	$3,500	0.7%
$820,000	$5,200	0.6%

There are also variations in average total annual cost depending on the mix of advisers used:

- Those currently using an accountant or tax agent to assist with their SMSF spend an average of $3,200 per year, including the accountants' services, managed fund MERs and all other costs outlined in section 6.2.
- Those currently using a financial planner (including those that also use an accountant) spend an average of $5,900 per year, including the planners' advice, managed fund MERs, and all other costs outlined in section 6.2. We note that planner-advised SMSFs tend to be larger than average and thus the higher dollar cost figure reflects both the planners' advice component, a higher proportion of assets in managed funds, and the higher average balances involved.
- The higher cost associated with SMSFs using a financial planner also reflects the fact that 40% of these funds are advised by both an accountant and a financial planner.
- The $3,500 overall average figure thus reflects the fact that only a minority (28%) of SMSFs use a financial planner and are paying for investment advice.

While the above figures suggest that SMSFs can often be a very effective cost structure, it is important to note that averages do not tell the whole story, and this result does not

mean they are cost-effective for everyone. To illustrate this point, among the 619 SMSFs taking part in the survey, there were:

- Five cases where SMSF balance was below $100,000 but annual fees were in the $5,000 to $6,000 range (i.e. cost per annum was at least 5%, and potentially much higher)
- Five cases where SMSF balance was below $100,000 but annual fees were in the $3,000 to $3,500 range (i.e. cost per annum was at least 3%, and potentially as high as 7%)
- Five cases where SMSF balance was below $100,000 but initial establishment costs were more than $6,000.

7 Insurance arrangements

Only one in four SMSFs have life insurance arranged through the fund

38% of SMSFs are interested in arranging life insurance through the fund:

- 24% already have life insurance through the fund
- 14% are interested in doing so

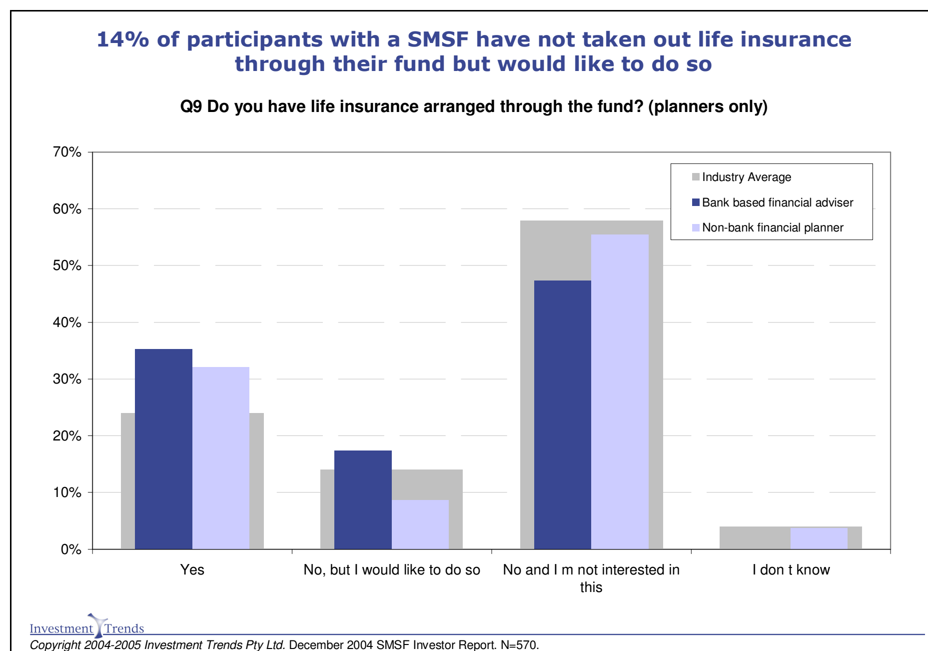
Insurance levels are better where an adviser is involved

Among financial planner SMSF clients:

- 32% already have life insurance through the fund
- 9% are interested in doing so

Among bank based adviser SMSF clients:

- 35% already have life insurance through the fund
- 17% are interested in doing so



While bank based planners' SMSF clients have a higher overall level of interest in having life insurance through the fund, these figures suggest that other financial planners have done a better job at bringing this issue to a conclusion, with fewer clients interested in this but not having insurance in place.

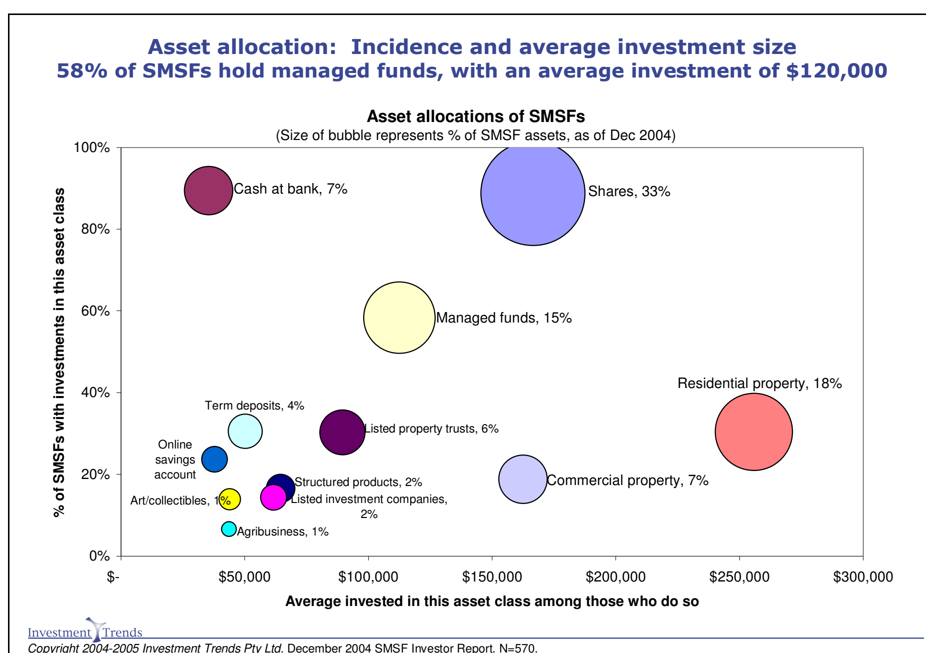
8 Investments used by SMSFs

8.1 Asset classes currently used

Shares and property are the dominant asset classes for SMSFs

SMSFs favour direct equity investments and use a range of different means to invest in property:

- 89% of SMSFs hold shares
- The average share portfolio among those doing so is $180,000
- 60% of SMSFs hold property of some kind within their self managed super
- 30% hold residential property, with a high average investment level of $280,000 reflecting gearing restrictions.
- 30% of SMSFs hold residential property.
- Residential property makes up 18% of total assets held within SMSFs
- A third of clients investing in residential property also invest in commercial property or listed property trusts
- 30% of clients hold listed property trusts within their SMSF
- If we add commercial property and listed property this raises the total proportion of assets to 31%



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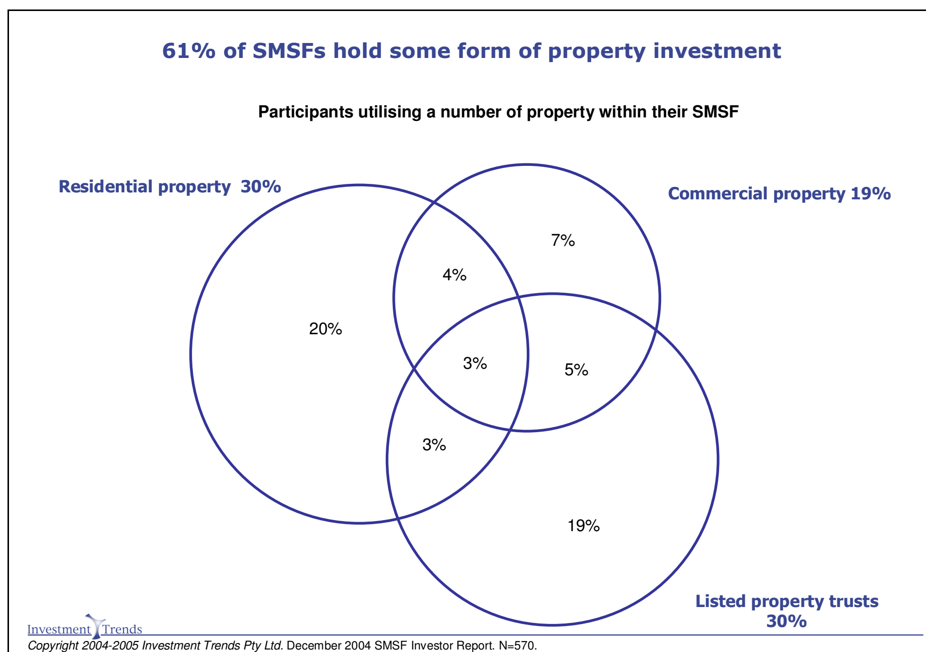
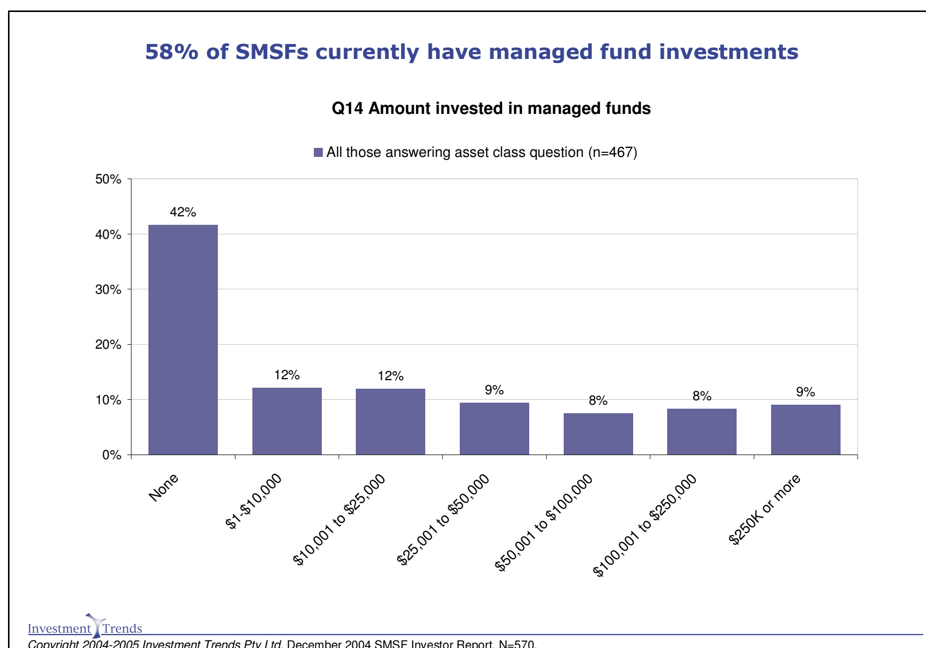


Managed funds are an important asset class within SMSFs

Some 58% of SMSFs hold managed fund investments, with an average holding of $120k.



Willingness to utilise managed fund usage is fairly high across different sizes of SMSFs:

- 60% of SMSFs with less than $100,000 in total assets utilise managed funds
- 51% of SMSFs between $100k and $250k utilise managed funds

➢ 66% of SMSFs of over $250k utilise managed funds

We note though that those larger SMSFs who utilised managed funds tended to invest a higher proportion of their total assets into managed funds than did low balance SMSFs utilising managed funds.

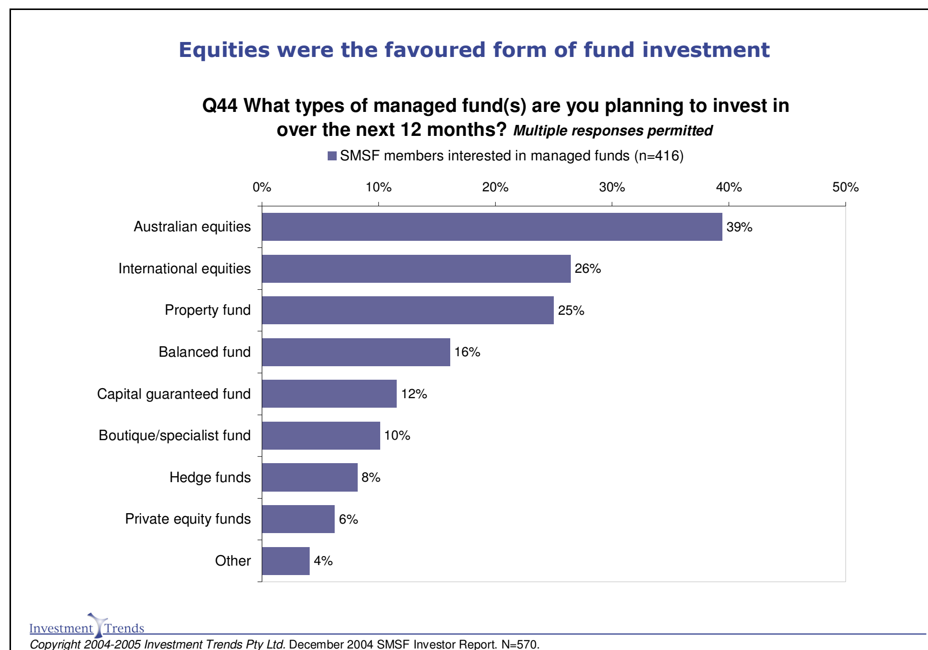
Future managed fund investments

SMSF members are also quite open to using managed funds going forward, with 78% indicating a willingness to do so. Among those interested, the most popular type of funds sought are:

➢ Australian equities (39%)

➢ International equities (26%)

➢ Property funds (22%)



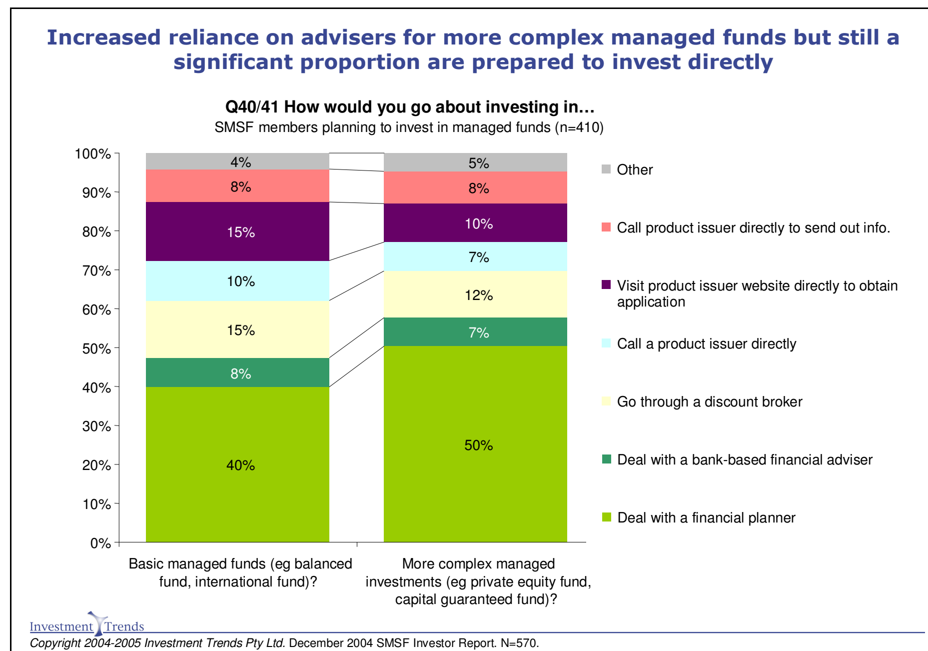
Half of those SMSFs planning to invest in managed funds do not plan to use an adviser to do so

Among those SMSFs planning to invest in funds, the preferred investment channels for doing so were:

➢ 48% say they would use a planner or bank based adviser to invest in basic managed funds

➢ This figure rises to 57% for more complex managed investments such as private equity funds

- 48% would prefer to invest directly or through a discount in basic managed funds, falling to 37% for complex funds



9 Methodology

IFSA commissioned Investment Trends to produce this report examining the self managed super fund SMSF) market. Analysis is based on two detailed quantitative surveys totalling 1,189 SMSF members conducted by Investment Trends. The findings in this report are excerpted from two of Investment Trends' syndicated reports:

October 2005 SMSF Investor Report
Calculations of total SMSF costs were conducted based on a survey of 619 SMSF members conducted by Investment Trends in October 2005. The survey focused on advice and fees in relation to SMSFs. This report is in production and will be available for subscription from November 2005. Certain assumptions were also based on the earlier December 2004 survey.

December 2004 SMSF Investor Report
Unless otherwise stated the findings in this report are drawn from the Investment Trends December 2004 Self Managed Super Fund (SMSF) Investor Report. This report was designed after extensive consultation with fund managers, SMSF administrators, SMSF members, financial planners and accountants, and it's results based on a survey of 570 SMSF trustees.

This survey was conducted in late December 2004. SMSF members were sourced from several research companies who had previously conducted broad based research which included asking whether people had a SMSF, and obtained permission to contact these people for future research. SMSF members were sent an email inviting them to participate in the SMSF survey. The survey was incentivised with prizes available based on a prize draw.

A total of 6,119 email invitations were sent. After data cleaning and de-duplication, 671 validated responses were received. The survey also incorporated a number of questions designed to eliminate those who thought they had a self managed super fund but did not. After this secondary cleaning phase, a final sample of 570 was available for analysis. Maximum sampling error (centre of the range) at 95% confidence interval for a sample of this size is +/- 4.1%. A slight bias to younger respondents was noted when comparing the survey sample to available ATO data on SMSF members. This was expected given the online methodology. A post-stratification weighting by age was used to correct this bias. No other weighting was required as the age-weighted sample otherwise conformed closely to known ATO data.

10 Further information

More extensive and detailed research on SMSFs is available on a subscription basis from Investment Trends:

- **December 2004 SMSF Investor Report**: This report gives a clear understanding of the motivations, intentions, influencers and preferences of SMSF members. Using this report financial services organisations can optimise product design, channel strategies and marketing messages. The report includes detailed coverage of:
  - The drivers, experiences and difficulties of running a SMSF
  - Investments, investment strategies, goals and behaviour
  - Dealing with advisers and product suppliers
  - Investment vehicles: share trading
  - Investment vehicles: managed funds
  - Investment platforms
  - Media Usage
  - SMSF Member Profile
- **2005 SMSF Investor Report**: This expands on the analysis in the 2004 report, provides tracking and includes additional information on adviser interactions, fees and costs involved in running a SMSF.
- **2005 SMSF Planner Report**: This report examines the activities, behaviour and needs of financial planners in relation to self managed super funds. It is based on a survey of over 350 financial planners conducted in October/November 2005.
- **2005 SMSF Accountant Report**: This report examines the activities, behaviour and needs of accountants in relation to self managed super funds and covers areas such as:
  - What services offered and needed around SMSFs.
  - Fee models and contestable fee streams.
  - In house investment advice and/or planner referral relationships

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ATTACHMENT D

Unit Pricing – Distribution of Investment Earnings

The differences that can occur between the use of crediting rates and use of unit pricing can be examined based upon the movement in the S&P/ASX200 Index for the 2004/05 year.

Assumptions:

- Investor in a fund that uses crediting rates, with $100,000 invested in an Australian share option as at 30 June 2004.
- The fund sets interim crediting rates at the start of each month. The interim crediting rate is calculated as the actual investment return to date plus an assumed rate of return for the next month (eg 8% pa). So the crediting rate for the month of December 2004 would be the actual earnings from 1 July 2004 to 30 November 2004; plus an assumed rate of 8% pa for the month of December 2004.
- The assumed rate of return of 8% pa is a proxy for the long term rate of return for the investment option adopted.
- Under this basis, the interim crediting rate for the month of December 2004 was 23.9% per annum.

Example 1 - Member leaves on 9 December 2004

Return under crediting rate system: (crediting rate of 23.9% pa)

Returns for 2004/05 to date	=	crediting rate x balance x time invested
	=	23.9% x $100,000 x 162 days/365 days
	=	$10,608

Returns under unit pricing: Investor will take the price of the index on 9 December, 2004

Returns for 2004/05 to date	=	Index rise %[24] x balance
	=	(3886.86/3532.89 – 1) x $100,000
	=	$10,019

Therefore in this example, the investor was over-credited $588. In effect, existing members in the fund are now collectively worse-off as there is a misallocation of the real returns from the market.

Example 2 - Member leaves on 24 December 2004

Return under crediting rate system: (crediting rate of 23.9% pa)

Returns for 2004/05 to date	=	crediting rate x balance x time invested
	=	23.9% x $100,000 x 177days/365days
	=	$11,590

Returns under unit pricing: Investor will take the price of the index on 24 December, 2004

Returns for 2004/05 to date	=	Index rise %[2] x balance
	=	(4048.60/3532.89 – 1) x $100,000
	=	$14,597

Therefore in this example, the investor was under-credited $3007. The investor is significantly worse off, and the additional returns that were supposed to be credited to this investor are misallocated to the remaining existing investors.

Crediting rate Calculations

The table below highlights the operation of a monthly crediting rate approach for the 2004/05 year assuming investment in an Australian shares option. The index adopted below is the

[24] Index rise is calculated by measuring the change in the S&P/ASX200 Index. Figures were accessed from: www2.standardandpoors.com

S&P/ASX200 as a representation of the performance of an Australian shares option. The estimated interim crediting rate in the table below is calculated as the actual investment return to date plus an assumed rate of return for the next month (eg 8% pa). The assumed rate of return of 8% pa is a proxy for the long term rate of return for the investment option adopted.

Final trading day of month	Index close	Estimated Interim Crediting Rate (pa)	Actual Return (pa)	Difference
30-Jun-04	3,532.89			
30-Jul-04	3,536.14	8.00%	1.11%	6.89%
31-Aug-04	3,552.69	4.55%	3.36%	1.19%
30-Sep-04	3,665.04	4.91%	14.96%	-10.05%
29-Oct-04	3,778.64	13.22%	20.87%	-7.65%
30-Nov-04	3,931.32	18.29%	27.07%	-8.77%
31-Dec-04	4,050.60	23.89%	29.31%	-5.42%
28-Jan-05	4,107.25	26.26%	27.87%	-1.61%
28-Feb-05	4,172.75	25.39%	27.17%	-1.78%
31-Mar-05	4,109.83	25.04%	21.77%	3.26%
29-Apr-05	3,983.17	20.40%	15.29%	5.10%
31-May-05	4,106.44	14.63%	17.71%	-3.08%
30-Jun-05	4,277.49	16.90%	21.08%	-4.18%

Example:
The crediting rate for the month of December 2004 would be the actual earnings from 1 July 2004 to 30 November 2004; plus an assumed rate of 8% pa for the month of December 2004. This is calculated as:

= 27.07%pa * 5 /12 (Return from 1/7/04 to 30/11/04) + 8%/12 (assumed Dec return)
= 11.28% + 0.67%
= 11.95% (or 23.9% per annum)

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ATTACHMENT E

IFSA draft Unit Pricing Standards

IFSA Standard No.8.00 - Scheme Pricing
IFSA Standard No. 9.00 - the valuation of Scheme assets and liabilities
IFSA Standard No. 17.00 - Incorrect Pricing of Scheme Units – Correction and Compensation

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IFSA Standard No. 8.00

Scheme Pricing

November 2006

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Main features of this Standard are:

- **The principles to be adopted in the calculation of Scheme prices;**
- **Guidance in relation to the application and interpretation of the above principles; and**
- **Specification of the practices, procedures and terminology required to standardise the pricing of Scheme interests.**

IFSA Standard No. 8.00

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IFSA Standard No. 8.00

1 Title

1.1 This Standard may be cited as IFSA Standard No. 8.00 "Scheme Pricing".

2 Standards and Commentary

2.1 The requirements set out in this Standard are shown in bold print. Commentary is shown in normal print immediately after the requirement to which it relates, as an aid to interpretation of the requirement.

3 Date of Issue

3.1 Originally issued 19 July 1999, updated June 2001, June 2002, February 2004 and 1 November 2006.

4 Effective Date

4.1 This Standard must be applied in relation to Scheme prices first determined on or after 1 July 2007. Earlier application of this Standard is permitted and encouraged.

5 Application

5.1 This Standard must be applied by the Operator of a Scheme (whether offered for public subscription or otherwise) in determining the price at which transactions in Scheme interests by Investors may take place except:

- **where the Scheme interests are quoted on the Australian Stock Exchange;**
- **where the Scheme Operator has obtained, in relation to the prices at which transactions by Investors in interests in a particular Scheme take place, an exemption from, or been granted relief under, the applicable legislation;**
- **where the prices at which interests in a Scheme are transacted do not affect the interests of other Investors (other than as provided by law).**

5.1.1 Where Scheme interests are quoted on the Australian Stock Exchange, Scheme prices applicable to transactions in interests of the Scheme (including the issue of further interests) are largely determined by the market rather than by the Scheme Operator. This Standard does not therefore apply to listed Schemes.

5.1.2 Where a Scheme Operator has obtained an exemption from, or been granted relief from the applicable legislation relating to the prices at which interests in a Scheme may be transacted, the requirements of this Standard should be modified accordingly

5.1.3 5.1.3 This Standard is primarily intended to apply to a Scheme where Investors' money is pooled so that each Investor has a proportionate interest in the Scheme Assets. If the property of each Investor is distinct, the price at which an interest is issued or realised does not affect the interests of the other Investors, and this Standard does not therefore apply.

DRAFT

5.1.4 While a transaction in an interest in a Scheme is usually between the Investor and a representative of the Scheme (such as a Responsible Entity), an Investor may also complete a transaction directly with the Scheme's Operator. Where required by law, this Standard applies to the determination of Scheme prices in relation to a transaction between a Scheme Operator and an Investor, and between a Scheme Operator and other Investors although the price applied to such transactions does not affect the interests of other Investors.

5.2 Where an IFSA Member's Scheme invests in a Scheme managed by an Associate, the requirements in this Standard apply, except:

- **where the Scheme managed by the Associate of the IFSA Member is subject to the laws, regulations, and generally accepted Scheme pricing practices of another country; or**
- **where the IFSA Member is unable to influence the process of determination of Scheme prices.**

5.2.1 Where a Scheme invests in a Scheme managed by an Associate of an IFSA Member it is clearly in the best interests of Investors to ensure that appropriate Scheme pricing standards are maintained in both Schemes.

5.2.2 IFSA Members must, to the best of their ability, ensure that an Associate complies with the requirements described in this Standard.

5.3 Where there is a conflict between the requirements of this Standard, applicable legislation, and the Constituent Document of a Scheme, the requirements of this Standard must, having regard to the purpose of this Standard, be modified appropriately. Any Scheme created on or after the Effective Date must comply with this Standard unless such compliance would conflict with applicable legislation, or the IFSA Member's interpretation of that legislation.

5.3.1 It is recognised that the Constituent Document of each Scheme will, while complying with applicable legislation, vary. Where a requirement of this Standard cannot be met (because to comply would conflict with the applicable legislation, the IFSA Member's interpretation of that legislation, or with the Constituent Document of a Scheme) a Scheme Operator must, as far as practicable, comply with the requirements of this Standard.

5.4 This Standard may not cover every situation faced by an IFSA Member in Scheme Pricing. Where a situation is not covered, an IFSA Member must have regard to the intent of the Standard as described in the Statement of Purpose and the Principles of Scheme Pricing.

5.4.1 Where a Scheme invests in a Scheme managed by an Associate of an IFSA Member it is clearly in the best interests of Investors to ensure that appropriate standards are applied to Scheme Pricing.

DRAFT

IFSA Standard No. 8.00

6 Statement of Purpose

6.1 The purpose of this Standard is:

- **to specify the principles to be adopted in the calculation of Scheme prices at which the transaction of an interest in a Scheme may take place, or an interest in the Scheme be valued;**
- **to provide guidance in the interpretation and application of those principles; and**
- **to standardise the practices and procedures, and terminology, relating to the pricing of Scheme interests.**

This Standard has been designed with reference to the Joint ASIC and APRA Unit Pricing Guide to Good Practice issued November 2005.

6.1.1 An Investor valuing his/her investment in a Scheme requires the Scheme price to be provided by the Scheme Operator to determine the investment value.

6.1.2 The valuation of the Scheme assets and liabilities is the key element in the determination of the price of an interest in a Scheme. The principles, practices and procedures to be adopted by Scheme Operators to ascertain the value of Scheme assets and liabilities are described in IFSA Standard No. 9.00 'Valuation of Scheme Assets and Liabilities'.

6.1.3 This Standard covers the determination of Scheme prices following a valuation of Scheme assets and liabilities determined in accordance with IFSA Standard No. 9.00 'Valuation of Scheme Assets and Liabilities'.

6.1.4 For historical reasons, combined with the requirement to hold a meeting of Investors (often at Investors' expense) to approve changes to the constituent document of a Scheme, there are within the industry a number of variations in practices and procedures used to determine Scheme prices.

6.1.5 It is desirable that there should be an industry-wide standard surrounding the pricing of Scheme interests which is consistent, fair to incoming, outgoing and continuing Investors, and which enables Investors and others to calculate the investment performance of a Scheme over different periods, and to compare that performance with that of other Schemes and investment opportunities. In particular, subparagraph 601FC(1)(d) of the Corporations Act 2001 requires a Responsible Entity of a registered managed investment Scheme to treat members in the same class equally and members of different classes fairly.

6.1.6 This Standard may not, however, cover every situation faced by IFSA Members in pricing an interest in a Scheme. Where a situation is not covered, an IFSA Member should have regard to the intent of this Standard as described in the Statement of Purpose.

6.2 Where an IFSA Member is, in relation to a Scheme, able to vary the Constituent Document of a Scheme without material additional cost to Investors or Scheme providers, the IFSA Member must incorporate within the Constituent Document all the changes necessary to ensure compliance with the requirements of this Standard.

6.2.1 The movement within the industry towards Scheme pricing uniformity will be accelerated where the Constituent Document of a Scheme is brought into line with the requirements of this Standard.

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7 Application of Materiality

7.1 The requirements in this Standard apply to the pricing of interests in a Scheme where such application is of material consequence. Failure by a Scheme Operator to adopt or implement a requirement is material if such failure has the potential to adversely affect:

- **an Investor's equitable interest in the Scheme Assets;**
- **other users of Scheme prices;**
- **a proper assessment of the investment performance of the Scheme, where investment performance is referenced to unit prices; and**
- **a decision by an Investor to allocate scarce resources.**

In deciding whether an item is material, its nature and amount usually need to be evaluated together. Further information on materiality in relation to errors in unit pricing can be found in Standard 17 – Incorrect Pricing of Scheme Units.

8 Definitions

8.1 In this Standard:

- **'Associate' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Constituent Documents' of a Scheme means the rules and regulations under which the Scheme exists;**
- **'Constitution' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Entry Price' means the Scheme price at which an Investor acquires an equitable interest in a Scheme;**
- **'Exit Price' means the Scheme price at which an Investor realises an interest in the Scheme;**
- **'Forward pricing' means that for an investor transaction received before instruction cut-off, the price will reflect a Valuation Point in the future (the price will be unknown at instruction time, and will be calculated in the future);**
- **'Historic pricing' means that for an investor transaction received before instruction cut-off, the price will reflect a Valuation Point in the past, normally the close of the business day before instruction day for domestic assets (the price will often be known or be able to be accurately predicted at instruction time, and will often have been calculated before instruction time);**
- **'IFSA Member' refers to a 'Full Member' as defined in IFSA's Articles of Association;**
- **'Interest' means an undivided portion of the equity of a Scheme;**

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- **'Investors' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Net Asset Value Price' means the Scheme price used to determine the Entry Price and Exit Price;**
- **'Operator', has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Prices', in relation to a Scheme, together mean the Entry Price and the Exit Price of that Scheme;**
- **'Scheme' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Scheme Assets' means the assets and liabilities of the Scheme, the valuation of which is determined in accordance with the IFSA Standard No. 9.00 'Valuation of Scheme Assets and Liabilities'; and**
- **'Valuation Point' means the point in time at which a cut-off is made to value the Scheme's Assets and Liabilities.**

9 Principles of Scheme Pricing

9.1 The process of determining Scheme prices in relation to a Scheme must meet the following criteria:

- **it must be equitable;**
- **it must be documented and transparent;**
- **it must be applied consistently; and**
- **it must be regularly reviewed.**

9.2 An equitable unit pricing process treats all types of investor fairly and does not favour:

- **transacting or non-transacting investors;**
- **current or future generations of investors; and**
- **different classes of investor (where applicable).**

9.3 An equitable unit pricing process must consider the impact of transacting investors on the Scheme. Consideration must be given to:

- **transaction cost factors;**
- **arbitrage opportunities;**
- **impact of backdating;**
- **frequency of pricing;**

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- **suspension of pricing;**
- **frequency of asset valuation;**
- **rounding adjustments;**
- **booking interests in a Scheme; and**
- **distribution reinvestment plans.**

10 Equitable unit pricing processes

10.1 Transaction Cost Factor

10.1.1 Scheme Operators must incorporate a 'transaction cost factor' in Scheme prices where identifiable transaction costs exist with respect to either the acquisition or disposal of Scheme Assets. The amount of any transaction cost factor must not accrue to the Scheme Operator.

10.1.2 Where there are separately identifiable material costs involved in the acquisition and/or the disposal of Scheme Assets (and those costs are not reflected in the valuation of Scheme Assets), Scheme prices must incorporate a 'transaction cost factor' or 'expense allowance' (transaction cost factor is also commonly known as a buy/sell margin or buy/sell spread).

10.1.3 The inclusion within the pricing process of a transaction cost factor acknowledges that acquisition or disposal costs (e.g. brokerage and stamp duty) have been incurred by Investors in acquiring or disposing of Scheme Assets, so that the interests of non-transacting Investors are not diluted by the activity of transacting investors.

10.1.4 Scheme Operators must estimate transaction costs and review methodologies at least annually. The methodology to estimate transaction costs must be documented and the process transparent.

10.1.5 The estimation of transactions costs must be limited to costs incurred at the point of trade execution and must exclude associated costs such as transaction based custody fees.

10.1.6 Where identifiable, brokerage costs incurred in exchange for provision of research must also be excluded. All such costs must be recorded as expenses of the fund.

10.1.7 In determining a transaction cost methodology, Scheme Operators must consider:

- changes to fundamentals of the Scheme or the market, for example, movements in the stamp duty rate.
- an allowance for market impact where the Scheme holds thinly traded assets with significant bid-offer spreads (if this has not been previously taken into account in valuing the thinly traded asset).
- an allowance for the netting effect of applications and redemptions where this has, in the past, had a significant and regular effect on the amount of transaction costs actually incurred by the Scheme.

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- The general direction of capital flows (ie, if the pool no longer accepts any contributions, only a selling cost allowance need be incorporated).

10.2 Arbitrage opportunities

10.2.1 Scheme Operators must understand and document the end-to-end pricing process and any aspects which may give rise to the opportunity to arbitrage.

10.2.2 Scheme Operators must understand how the design of the pricing process across legacy, current and proposed products may give rise to the opportunity to arbitrage.

10.2.3 Opportunities to arbitrage exist in Historic Pricing environments and may exist in a Forward Pricing environment.

10.2.4 Opportunities to arbitrage may arise from:

- unit prices being calculated less frequently than the frequency of asset valuations;
- unit prices being calculated less frequently than the frequency of transacting;
- an investor transaction received before instruction cutoff receiving the last calculated price;
- delays within the end-to-end asset valuation process including service provider processes;
- the availability of asset valuation information at instruction cut-off time.
- The release of price sensitive information prior to these being incorporated into scheme pricing.

10.2.5 To determine whether a delay exists in asset valuation that can be exploited by Investors, the relationship between the Valuation Point(s) of the asset(s) and instruction cut-off times must be investigated.

10.2.6 Within fund-of-fund structures, additional delays may exist when investing into external unit trusts. Scheme Operators must understand the end-to-end pricing process to determine the extent of any delays in asset valuation.

10.2.7 Scheme Operators must consider the adoption of a response plan, to be invoked when an event has occurred that creates an arbitrage opportunity. Actions may include suspension of scheme pricing and / or changes in the frequency of scheme pricing.

10.2.8 Scheme Operators must have a process in place to minimise arbitrage opportunities.

10.2.9 Appropriate steps may include but are not limited to:

- monitoring investor activity to identify activity that may constitute arbitrage
- introducing fees for frequent switching
- introducing a period of delay to applications or switches to make arbitrage uneconomic

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10.2.10 Where inappropriate activity has been identified, Scheme Operators must determine the facts of the case and what powers are available to the Scheme Operator (if any) to address the inappropriate activity. Scheme operators must document decisions made (including the decision to take no action).

10.3 Impact of Backdating

10.3.1 Scheme Operators must have a backdating policy in place, documenting under what circumstances impacts of backdating will be funded by the Scheme Operator.

10.3.2 Regardless of approach, the Scheme Operator must have a process in place to monitor the backdating of transactions and fund any unreasonable impacts as defined by the Scheme Operators policy.

10.3.3 Backdating occurs when the unit price given to a transaction is different to the unit price that must be used to process other transactions in the Scheme on the same date. Backdating can occur as a result of processing turnaround times and processing errors. Backdating is a feature of unitised products and the impact can be either positive or negative. Impacts of backdating are not borne by the transacting investor but by non-transacting investors.

10.4 Frequency of pricing

10.4.1 Where interests in a Scheme are transacted on a basis less frequently than daily, Scheme prices must be determined at least as frequently as Scheme interests are transacted. Scheme prices should generally be determined on a daily basis.

10.5 Suspension of pricing

10.5.1 A Scheme Operator must suspend transactions in the interests of a Scheme where Scheme prices cannot be determined. The Scheme Operator must also consider suspending transactions in the interests of a Scheme where a material dilution of Investor's interest will occur (such as when a significant market movement has occurred).

10.6 Frequency of asset valuation

10.6.1 Valuation of Scheme assets and liabilities should occur as frequently as interests in the Scheme may be transacted. Where less frequent valuations are made (typically due to the nature of the asset), Scheme operators must satisfy themselves that equity is maintained between transacting and non-transacting investors.

10.6.2 Scheme prices are determined from a valuation of Scheme Assets made at a specific point in time (the 'Valuation Point'). By entering into a transaction in Scheme interests immediately after a Valuation Point the Investor can ensure that the price he or she pays is as close to the true value of an interest as possible.

10.7 Rounding adjustments

10.7.1 Scheme operators must not accrue any rounding adjustment. Rounding adjustments must remain in the fund at all times.

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10.8 Booking Investments in a Scheme

10.8.1 Interests in a Scheme must not be issued prior to receipt of funds by the Scheme, where potential for a material dilution of investor interests exists.

10.8.2 The practice of issuing, reserving, or booking units to an investor in a Scheme prior to the receipt of funds (which includes receipt of drawdown directions under direct debit arrangements, receipt of promissory notes or negotiable instruments or other rights to payment or intangible property, provided that they are permitted by Scheme constitutions, and receipt of funds into the Scheme application account) is not acceptable (where this is inconsistent with the constitution or otherwise in breach of law). This is because the interests of existing Investors may be diluted by the amount of any increase in the value of the Scheme Assets attributable to that Investor prior to the receipt by the Scheme of the Investor's application monies. These monies could have been invested for the benefit of all Investors with interests in the Scheme.

10.8.3 Where Scheme operators invest into internal Schemes as a means of gaining exposure to particular asset classes it is acceptable practice to issue units prior to the receipt of funds on the proviso that funds will be received within the settlement date cycle applicable to the underlying assets of that Scheme (e.g. trade date plus 3 for equities). This enables Scheme operators to trade between asset classes whilst still maximising exposure to the market.

10.9 Distribution Reinvestment Plans

10.9.1 Interests in a Scheme issued in relation to a distribution reinvestment plan must be issued at a Scheme price and using a methodology which ensures equity is maintained.

10.9.2 Where the Investors are entitled to an income distribution from a Scheme, the entitlement generally arises at a point specified in the Scheme's Constituent Document. An Investor may be required, or may elect, to utilise an income entitlement as an application for additional interests in a Scheme. The calculation of an amount of an Investor's income entitlement may not be completed for some time after entitlement, and therefore the distribution payment date is likely to be different to the income entitlement date.

10.9.3 The reinvestment process used and the date on which the reinvestment price is based must not materially disadvantage any particular Investor or Investor with respect to any other Investor. The reinvestment price must be the Net Asset Value price.

10.9.4 Election by an Investor to utilise an income entitlement as an application for additional interests in a Scheme must be made before income has been distributed from the Scheme. This is to avoid Investors gaining advantage through hindsight actions.

11 Documented and transparent unit pricing processes

11.1 Members must have a policy framework in place that documents the adoption of the Principles of Scheme Pricing. The policy framework must include, at a minimum:

- **Delegated authorities and accountabilities;**
- **Reporting requirements;**
- **Processes to confirm the completeness of and compliance with policies;**

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- **Training requirements for policy awareness;**
- **The alignment of procedures to policies;**
- **Ongoing review of policies and procedures; and**
- **Outsourcing arrangements (where appropriate).**

12 Consistent unit pricing processes

12.1 Scheme Pricing policies must be applied consistently and exceptions to documented policies, processes and procedures must be clearly documented at the time an alternative policy, process or procedure is used.

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IFSA Standard No. 9.00

Valuation of Scheme Assets and Liabilities

November 2006

Main features of this Standard are:

- **Specification of the principles to be adopted in the Valuation of Assets and Liabilities of a Scheme;**
- **Provision of guidance in the interpretation and application of those principles; and**
- **To standardise the practices and procedures relating to the valuation of the Assets and Liabilities of a Scheme and the determination of the Net Asset Value of a Scheme.**

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IFSA Standard No. 9.00

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IFSA Standard No. 9.00

1 Title

1.1 This Standard may be cited as IFSA Standard No. 9.00 'Valuation of Scheme Assets and Liabilities'.

2 Standards and Commentary

2.1 The requirements set out in this Standard are shown in bold print. Commentary is shown in normal print immediately after the requirement to which it relates, as an aid to interpreting the application of the requirements.

3 Date of Issue

3.1 Originally issued 19 July 1999; updated 22 June 2001, February 2004 and 1 November 2006.

4 Effective Date

4.1 This Standard must be applied in relation to the valuation of Assets and Liabilities of a Scheme made on or after 1 July 2007. Earlier application of this Standard is permitted and encouraged.

5 Application

5.1 This Standard must be applied by the Scheme Operator (whether offered for public subscription or otherwise) in relation to that Scheme.

5.2 This Standard must be applied by the Scheme Operator in relation to the valuation of Scheme Assets and Liabilities for:

- **the purpose of calculation of the Net Asset Value. The Net Asset Value of a Scheme is then used to determine Scheme Prices in accordance with IFSA Standard No. 8.00 'Scheme Prices'; and**
- **the purpose of valuation of non-cash Assets accepted by the Scheme in consideration for an issue of interests in the Scheme.**

This Standard may not apply where the Scheme Operator has obtained an exemption from, or been granted relief under, the applicable legislation in relation to the valuation of Scheme Assets and Liabilities.

5.2.1 A Scheme may accept non-cash Assets (such as real property) as consideration for an issue of interests in the Scheme. This Standard applies to the valuation of non-cash Assets introduced to a Scheme in consideration for interests issued at a price determined in accordance with IFSA Standard No. 8.00 'Scheme Pricing'.

5.3 Where there is a conflict between the requirements of this Standard, applicable legislation, and the Constituent Documents of a Scheme, the requirements of this Standard should, having regard to the purpose of the Standard, be modified appropriately so that, as far as practicable, the Scheme Operator complies with the requirements of this Standard.

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5.4 This Standard may not cover every situation faced by an IFSA Member in the valuation of Scheme Assets and Liabilities and in the determination of the Net Asset Value of a Scheme. Where a situation is not covered, an IFSA Member must have regard to the intent of the Standard as described in the Statement of Purpose and the Principles of Valuation of Scheme Assets and Liabilities.

In all circumstances IFSA Members must make reference to applicable Australian Accounting Standards and generally accepted accounting principles in determining whether the concepts used in the valuation of Scheme Assets and Liabilities are appropriate, and where different, clearly understand the differences.

5.4.1 Where a Scheme invests in a Scheme managed by an Associate of an IFSA Member it is clearly in the best interests of Investors to ensure that appropriate standards are applied to the valuation of Scheme Assets and Liabilities.

5.4.2 IFSA Members must, where possible, ensure that an Associate complies with the requirements described in this Standard before recommending investment of Scheme Assets in a Scheme managed by the Associate and during a period in which the Scheme holds interests in that Scheme.

6 Statement of Purpose

6.1 The purpose of this Standard in relation to the valuation of the Assets and Liabilities of a Scheme and the determination of the Net Asset Value of a Scheme is:

- **to specify the principles to be adopted;**
- **to provide guidance in the interpretation and application of those principles;**
- **to standardise the practices and procedures; and**

This Standard has been designed with reference to the Joint ASIC and APRA Unit Pricing Guide to Good Practice.

6.1.1 The valuation of Scheme Assets and Liabilities is the key determinant of the Net Asset Value of the Scheme, the price of an interest in the Scheme, and the investment performance of the Scheme.

6.1.2 The primary purpose of the valuation of Scheme Assets and Liabilities is to determine the prices at which Scheme interests may be transacted. The principles, practices and procedures to be adopted by a Scheme Operator to ascertain the price of an interest in a Scheme are described in IFSA Standard No. 8.00 'Scheme Pricing'.

6.1.3 However, the Valuation of Scheme Assets and Liabilities is also important in that it determines the Net Asset Value which is commonly used to determine a Scheme Operator's entitlements and other entitlements under the Constituent Documents of the Scheme. The Net Asset Value may also determine the amount of other expenses payable from the Assets of the Scheme (for example, expenses reimbursable to the Scheme Operator).

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6.1.4 While it is generally expected that Scheme Operators use the same valuation basis for pricing Scheme interests, for the purposes described in paragraph 6.1.3, and for reporting the value of Scheme Assets and Liabilities in the financial statements of a Scheme, there need be no requirement to do so. While Scheme prices are primarily determined for the purpose of maintaining equity between Scheme Investors and potential and exiting Investors, financial statements of a Scheme are generally produced at a later date, and the impact of new information subsequent to the unit pricing date may necessitate amendments to the value of certain Assets and Liabilities. Also, the method for calculation of entitlements may be dependent on the Constituent Documents of a Scheme, which may not be entirely compatible with the principles and procedures, outlined in this Standard. If a different valuation basis is used for any of the above mentioned purposes, details about the basis, the purpose of and reasons for its use must be documented appropriately.

6.1.5 The asset valuation process adopted by a Scheme Operator should reflect legislative requirements and requirements under the Scheme's Constituent Documents.

6.1.6 As the process of valuation of Scheme Assets and Liabilities is significant to Investors and other users of Scheme prices, and may involve the application of subjective judgement, it is appropriate that this Standard provides guidance in the interpretation and application of the principles to be adopted in the valuation of Scheme Assets and Liabilities and in the determination of the Net Asset Value of a Scheme.

6.1.7 Comparison of the investment performance of a Scheme with that of another Scheme will be enhanced where similar processes of valuation are used. It is clearly desirable that uniformity be adopted within the managed investments, superannuation and life insurance industries in relation to the process of valuing similar Assets and Liabilities.

6.2 Where an IFSA Member is, in relation to a Scheme, able to vary the Constituent Document of a Scheme without material additional cost to Investors or Scheme providers, the IFSA Member must incorporate within the Constituent Document all the changes necessary to ensure compliance with the requirements of this Standard.

6.2.1 The movement within the industry towards Valuation of Scheme Assets and Liabilities uniformity will be accelerated where the Constituent Document of a Scheme is brought into line with the requirements of this Standard.

Application of Materiality

7.1 This Standard applies to the valuation of interests in a Scheme and the determination of the Net Asset Value of the Scheme where such application is of material consequence. Failure by a Scheme Operator to adopt or implement a requirement is material if such failure has the potential to affect:

- **Investors equitable interest in the Scheme's Assets;**
- **other users of Scheme prices;**
- **a proper assessment of the investment performance of the Scheme;**
- **a decision by Investors to allocate scarce resources (investment funds); and**
- **the calculation of entitlements based on Scheme Assets and Liabilities.**

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In deciding whether a failure by a Scheme Operator to adopt or implement a requirement is material, its nature and amount in relation to the Scheme needs to be evaluated. Further information on materiality in relation to errors in unit pricing can be found in Standard 17 – Incorrect Pricing of Scheme Units.

8 Definitions

8.1 In this Standard:

- **'Associate' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Assets' are defined in accordance with applicable Australian Accounting Standards and generally accepted accounting principles;**
- **'Constituent Documents' of a Scheme means the rules and regulations under which the Scheme exists;**
- **'Entry Price' means the Scheme price at which an Investor acquires an equitable interest in a Scheme;**
- **'Exit Price' means the Scheme price at which an Investor realises an interest in the Scheme;**
- **'Gross Assets' means the total Assets of a Scheme before allowances for costs of acquisition or disposal and before deduction of Scheme Liabilities;**
- **'Interest' means an undivided portion of the equity of a Scheme;**
- **'Investors' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions ;**
- **'Liabilities' are defined in accordance with applicable Australian Accounting Standards and generally accepted accounting principles. IFSA Members must be mindful that where Liabilities are referred to throughout this Standard these include, but are not limited to, tax provisions, expenses, ongoing management fees and performance fees but exclude liabilities relating to unit holder / policy holder balances;**
- **'Market Price' means the last sale price immediately prior to the Valuation Point or the current price available at the Valuation Point from a market maker;**
- **'IFSA Member' refers to a 'Full IFSA Member' as defined in IFSA's Articles of Association;**
- **'Net Asset Value' of a Scheme means the result obtained by deduction of the value of Liabilities of a Scheme from the value of Gross Assets of a Scheme;**
- **'Operator', in relation to a Scheme, has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Prices', in relation to a Scheme, together mean the Entry Price and the Exit Price of that Scheme;**

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- **‘Scheme’ has the same meaning as in IFSA Guidance Note No. 5.00 ‘Industry Terms and Definitions’; and**

- **'Valuation Point' means the point in time at which a cut-off is made to value the Scheme's Assets and Liabilities.**

9 Principles of Valuation of Scheme Assets and Liabilities

9.1 The processes of valuing Scheme Assets and Liabilities and determining the Net Asset Value of the Scheme must meet the following criteria:

- **they must be documented and transparent;**
- **they must be unbiased and equitable; and**
- **they must be applied consistently.**
- **they must be reviewed regularly.**

9.1.1 The valuation of Scheme Assets and Liabilities must be documented, unbiased and applied consistently as it forms the basis of Scheme Prices, performance and calculation of entitlements.

9.1.2 Where a Scheme allows for Investors with different classes of interest, the valuation of Scheme Assets and Liabilities must be fair to each class and in accordance with the Scheme's Constituent Documents and the Corporations Act.

10 Application of Principles of Valuation of Scheme Assets and Liabilities: documented and transparent

10.1 IFSA Members must have a policy framework in place that documents the Valuation of Scheme Assets and Liabilities. The policy framework must include, at a minimum:

- **Delegated authorities and accountabilities;**
- **Reporting requirements;**
- **Processes to confirm the completeness of and compliance with policies;**
- **Training requirements for policy awareness;**
- **The alignment of procedures to policies;**
- **Ongoing review of policies and procedures; and**
- **Outsourcing arrangements (where appropriate).**

10.2 IFSA Members must document and explain the methodologies and assumptions used in valuing Scheme Assets and Liabilities.

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11 Application of Principles of Valuation of Scheme Assets and Liabilities: unbiased and equitable

11.1 The valuation of a Scheme's Assets and Liabilities must be based on the market value of all Assets and Liabilities.

11.1.1 The Gross Assets of a Scheme include the investments of the Scheme, and all other amounts due to and receivable by the Scheme - for example, claims for the repayment of tax levied before the Valuation Point (where applicable) and accrued interest, dividends or rent.

11.1.2 The Liabilities of a Scheme may include amounts payable by the Scheme in relation to investments and (where applicable) in respect of taxation relating to completed accounting periods and the current accounting period (up to the Valuation Point); the amount of the Scheme Operator's other entitlements and any reimbursable expenses accrued i.e. management fees and performance fees unpaid; any interest accrued on the borrowing's of the Scheme and all other Liabilities payable out of the Gross Assets of the Scheme.

11.2 The value of Assets and Liabilities used in determining the Net Asset Value of a Scheme must be determined by reference to market values.

11.2.1 The Market Price must exclude any provision for the costs of acquisition or disposal of a Scheme asset. Costs of acquisition or disposal of a Scheme asset are allowed for, in the transaction cost factor determined in accordance with IFSA Standard No. 8.00 'Scheme Pricing'.

11.2.2 Some Scheme Assets and Liabilities (for example money market instruments, mortgage securities and the derivatives associated with these assets) may be valued at other than Market Price. This is particularly relevant to Cash Management Schemes. Should this assumption be inappropriate at a particular Valuation Point, (for example, if the Scheme Operator expects an asset to be liquidated) a valuation at Market Price must be obtained and adopted in the valuation of Scheme Assets and Liabilities.

11.3 Where Assets and Liabilities are traded on a properly regulated market (such as a recognised stock exchange) valuations must be based on the Market Price. However, on the rare occasion when:

- **the Market Price is deemed to be unreliable; or**
- **no Market Price is available;**

the valuation of Scheme Assets and Liabilities must be determined in good faith by the Scheme Operator. In such circumstances the Scheme Operator must be satisfied that all relevant factors have been considered in determining the value of the Scheme's Assets and Liabilities and that any exceptions to documented policies and methodologies are clearly documented at the time an alternative valuation is used.

11.3.1 Where Scheme Assets are traded on more than one properly regulated market, the Scheme Operator must value the asset on the basis of the primary market for the asset.

11.3.2 Market Price to be used in any valuation must be the most recent (at the Valuation Point) which can be reasonably obtained.

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11.3.3 If Assets and Liabilities have been traded infrequently, or if the market in those Assets and Liabilities is thin, the Market Price may be unreliable. In such instances, the Scheme Operator must, in good faith, adopt a valuation where all relevant factors have been considered in determining the value of the Scheme's Assets and Liabilities.

11.4 Where Assets and Liabilities for which there is no properly regulated market are required to be valued a Scheme Operator must, unless it is inappropriate, obtain a valuation from a reputable, independent third party (such as a professional valuer or tax agent), or must be based upon sound and justifiable policies.

11.4.1 A professional valuer must be properly briefed as to the purpose of the valuation of the Scheme Assets and the basis on which the valuation is to be determined (including any legislative requirements, and requirements of the Scheme's Constituent Documents and/or Product Disclosure Statement or equivalent document).

11.4.2 The Scheme Operator must provide all the information the valuer may require to complete the valuation.

11.4.3 In certain circumstances where there is no properly regulated market for Assets and Liabilities, it may be neither appropriate nor necessary for particular Assets or Liabilities to be valued by a third party. Examples of such Assets and Liabilities are interests in other Schemes managed by the Scheme Operator or by another Scheme Operator, outstanding settlements, provision for tax, performance fees, and trustee and Scheme Operator's fees payable. For these Assets and Liabilities the respective valuations must be determined by the Scheme Operator based upon sound and justifiable policies which have been clearly documented. Such policies must seek to achieve equity between investors, and must be regularly reviewed.

11.4.4 Similarly, the value of realised and unrealised tax losses and the like must be determined so as to favour neither a seller nor a buyer of Scheme interests.

11.4.5 The value of such losses is dependent on future events including the amount of taxable income or gains generated by the fund, any increase or decrease in the size of the fund and the extent to which future capital gains may be entitled to the discount allowed for assets held for more than 12 months.

11.4.6 Given these uncertainties a valuation process is likely to conclude that there is a range of acceptable values rather than a single number. Nevertheless unit pricing requires the use of a single number. The Scheme Operator must choose the number within that range of values that in their judgment has the least bias in favour of either a seller or buyer of Scheme interests.

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11.5 The valuation of the Assets and Liabilities of a Scheme must be objective and not subject to undue influence by the Scheme Operator (or associate) and must be independently verifiable.

11.5.1 The valuations adopted by a Scheme Operator in calculating the Net Asset Value of a Scheme must be determined using Market Prices obtained from a reliable independent source.

11.5.2 A number of sources of Market Prices are currently available. A Scheme Operator must ensure that the basis on which Market Prices are supplied is in compliance with the applicable legislation and the Constituent Documents.

11.5.3 Where a Market Price obtained from an independent source is amended by the Scheme Operator for the purpose of valuation (for example, where the Market Price supplied is based on an insignificant or non-arms length transaction), or where no Market Price is available (for example, a share price is suspended), a Scheme Operator must ensure that the price adopted in the valuation is determined in good faith, is documented at the time of amendment and is in accordance with applicable Australian accounting standards.

11.6 Where, at a Valuation Point, the valuation of Scheme Assets and Liabilities cannot be determined, and to process transactions in an interest in the Scheme has the potential to prejudice Investors, the Scheme Operator must suspend such transactions until the value of the Scheme's Assets and Liabilities can be determined.

11.6.1 A valuation may not be able to be determined for a variety of reasons - for example, where there is a disruption to the information flow necessary to establish the Assets and Liabilities of the Scheme; where markets on which Scheme Assets are traded are closed or restricted and Market Prices cannot be established; where valuations cannot in good faith be estimated by the Scheme Operator (for example, where significant Assets must be disposed of quickly to meet the liquidity requirement of the Scheme).

11.6.2 If the valuation of a Scheme cannot be determined, a transaction in interests of the Scheme must not be processed.

12 Application of Principles of Valuation of Scheme Assets and Liabilities: applied consistently

12.1 The valuation must include all of the Assets and Liabilities of a Scheme at the Valuation Point.

12.1.1 At each Valuation Point the Scheme Operator must ensure that all the Assets and Liabilities of a Scheme are properly recognised and accounted for in accordance with applicable Australian Accounting Standards (where these are applicable for Scheme Pricing purposes) and generally accepted accounting principles. Completeness is essential if fairness and accuracy is to be achieved in the valuation of Scheme Assets and Liabilities and in the pricing of an interest in a Scheme.

12.1.2 It is generally not appropriate to include an amount within the Assets and Liabilities of the Scheme that is used to smooth the effect of an error or more up to date information.

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12.1.3 Income receivable by a Scheme up to the Valuation Point must be included in Scheme Assets on a basis consistent with the valuation of Scheme Assets. For example, investment income from shares must be recognised as receivable when securities are marked 'ex-dividend'.

12.2 The Net Asset Value of a Scheme at the Valuation Point must be calculated by deducting from the value of a Scheme's Gross Assets the value of the Liabilities of the Scheme.

12.3 Scheme Assets and Liabilities must be valued assuming a "going concern" basis of the Scheme, unless this assumption is clearly inappropriate.

12.3.1 A "going concern" basis for the Scheme assumes that the Scheme will continue to operate indefinitely. As such, Scheme Assets and Liabilities must be valued at market value, which ignores the impact on that valuation should the Assets or Liabilities actually be acquired or realised.

12.3.2 An example of where a "going concern" basis may not be appropriate is where a Scheme is in the process of being wound up.

12.3.3 The Market Price of an asset applied in the valuation of Scheme Assets need not necessarily reflect the liquidation value of the asset. For example, where the Scheme's holding of shares greatly exceeds the volume recently traded at the Market Price it is likely that the amount obtainable for the total holding would, should that holding be sold, be significantly different to the Market Price. Consequently, the valuation of Scheme Assets does not necessarily reflect the liquidity of a Scheme's Assets.

12.4 Where the Market Price (or other valuation) of an Asset or a Liability of a Scheme is denominated in a currency of another country, the exchange rate to be used in converting the valuation to the base currency must be determined at the Valuation Point on the basis of either the last exchange rate at which a transaction in that currency took place or at the WM Reuters 4pm London Exchange Rates. The basis selected to be used must be consistently applied over time.

12.4.1 Exchange rates must be obtained from the same source wherever possible.

12.5 Scheme Assets and Liabilities must be valued at least as frequently as interests in the Scheme may be traded, except where the practicalities of valuation are such that it is, in the opinion of the Scheme Operator, in the best interests of Investors to initiate less frequent valuations.

12.5.1 The minimum frequency at which a valuation of Scheme Assets and Liabilities is made may be laid down in the legislation applicable to the Scheme or in the Constituent Documents. Scheme Operators may decide that valuations of Scheme Assets and Liabilities should be made more frequently than the prescribed minimum (including intra-day pricing where the systems capability of the Scheme Operator allows) where it is in the best interests of Investors.

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12.6 Where the formal valuation of certain Scheme Assets and Liabilities is at extended, infrequent intervals (for example, where valuation occurs less frequently than Scheme prices are struck), valuation policies must be developed which limit the occurrence of sudden significant increases or decreases in Net Asset Value which do not reflect a true sudden increases or decreases in underlying value of Assets and Liabilities. Such policies should include the staggering of formal valuations of Assets and Liabilities within the Sceme during the intervening period. Where appropriate, consideration should be given to reflecting estimated movements or general market movements between formal valuations.

12.6.1 Some Scheme Assets and Liabilities by their nature (and partly as a result of the costs of obtaining a valuation) are subject to formal valuation at infrequent intervals (e.g. real property, infrastructure, private equity). Such Assets and Liabilities normally are identified as trading in a low volume, semi-liquid market or could be an interest in Schemes where valuation occurs less frequently than Scheme prices are struck. The value of these Assets and Liabilities must be determined at least annually as a minimum,.

12.6.2 Policies for limiting inappropriate sudden significant increases or decreases in Net Asset Value during the intervening period between formally valuations should include:

- where there are two or more such Assets or Liabilities with long periods between formal valuations, each Asset or Liability is formally valued at predetermined, regular intervals, and formal valuation of each asset is staggered evenly across the year to avoid concentration of the impact of changes to Net Asset Value to a particular point in time; and

- where the Scheme Operator believes that there has been a significant movement in the true underlying value of an Asset or Liability between formal valuations, the Scheme Operator should consider reflecting this movement in the valuation used for unit pricing purposes (e.g. by using an estimated movement or general market movement).

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IFSA Standard No. 17.00

Incorrect Pricing of Scheme Units – Correction and Compensation

November 2006

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Main features of this Standard are:

- **Specification of the principles that a Scheme Operator is expected to follow when dealing with the incorrect pricing of scheme units; and**
- **Specification of certain minimum requirements for a Scheme Operator when compensating on occasions when incorrect pricing takes place.**

IFSA Standard No. 17.00

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IFSA Standard No. 17.00

1 Title

1.1 This Standard may be cited as IFSA Standard No. 17.00 ‘Incorrect Pricing Of Scheme Units - Correction and Compensation’.

2 Standards and Commentary

2.1 The requirements set out in this Standard are shown in bold print. Commentary is shown in normal print immediately after the requirement to which it relates, as an aid to the interpretation of the requirement.

3 Date of Issue

3.1 Originally issued 19 July 1999 and updated 1 November 2006

4 Effective Date

4.1 This Standard must be applied in relation to an IFSA Member’s operations on or after 1 July 2007. Earlier application of this Standard is permitted and encouraged.

5 Application

5.1 This Standard must be applied by the Operator of a Scheme (whether offered for public subscription or otherwise) in relation to that Scheme.

5.2 Where there is a conflict between the requirements of this Standard, applicable legislation, and the Constituent Documents of a Scheme, the requirements of this Standard must, having regard to the purpose of the Standard, be modified appropriately so that, as far as practicable, the Scheme Operator complies with the requirements of this Standard.

6 Statement of Purpose

6.1 The purpose of this Standard is to set minimum requirements:

- **for occasions when incorrect prices have been calculated and transacted upon; and**
- **for determining when compensation is required that arises as a result of incorrect unit prices.**

This Standard has been designed with reference to the Joint ASIC and APRA Unit Pricing Guide to Good Practice issued November 2005.

6.2 IFSA Standard No. 8.00 'Scheme Pricing' covers the determination of Scheme prices following a valuation of scheme assets determined in accordance with IFSA Standard No. 9.00 'Valuation of Scheme Assets and Liabilities'.

6.3 The duty of the Scheme Operator extends to taking all reasonable steps, and exercising due diligence, to ensure the Scheme is correctly priced.

6.4 The appropriate treatment of incorrect pricing has been a recurring administrative problem amongst Scheme Operators.

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6.5 The Scheme Operator has a fiduciary duty to act in the best interest of Scheme Investors, and must exercise discretion in accordance with this duty in any particular case. IFSA has issued this Standard to provide requirements for Scheme Operators to ensure that they act in the best interest of Scheme Investors on a consistent basis; however the requirements are not intended to be exhaustive.

7 Application of Materiality

7.1 This Standard applies to the treatment of errors in the pricing of interests in a Scheme. In forming a policy for managing such errors, a Scheme Operator may choose to use a level of materiality to assess whether an error requires compensation to be considered for individuals in a Scheme, or the Scheme itself. For the purposes of this Standard, the materiality used for such an assessment must be no more than 0.3% of the price of a unit.

7.1.1 The size of a unit pricing error can be assessed by measuring the size of the variance between the incorrect unit price and the correct unit price, as a percentage of the correct unit price, at a particular point in time. The calculation must allow for all known errors present in the unit price at the time of assessment. Where the size of the unit pricing error is above the adopted materiality threshold, it is then necessary to look at the implications of the incorrect price to determine what compensation is required.

7.1.2 The Scheme Operator must also consider whether it is appropriate to apply a materiality test to the effect of the error on individual Investor benefits. This may be appropriate, for example, where the size and direction of a unit pricing error has been variable, but the error has not resulted in the Scheme's unit price being wrong by more than the adopted materiality threshold.

7.1.3 In setting materiality thresholds, the Scheme Operator must consider:

- The nature of the assets of the Scheme;
- The nature of the error;
- Any other circumstances or obligations which may suggest that a lower materiality threshold is appropriate.

7.1.4 A situation where a lower materiality threshold may be appropriate is a fund that only holds cash assets, where a reasonable materiality threshold for a Scheme may be 0.05%.

7.2 Where the Scheme Operator has financially benefited from an error, the Scheme Operator must pay compensation such that the Scheme Operator does not retain the financial benefit.

7.2.1 Where compensation is payable under paragraph 7.2, the compensation may be payable to the Scheme, or to individual past and present Investors, based upon the materiality threshold adopted as per paragraph 7.1 and taking into account the legislative obligations of the Scheme Operator.

7.3 A sample Decision tree has been provided as Appendix 1 to this Standard to provide guidance to IFSA Members in managing and assessing pricing errors.

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8 Definitions

8.1 In this Standard:

- **'Associate' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Compensatable Error' means a unit pricing error where the impact of the error on the price of a unit is greater than the materiality threshold adopted in accordance with paragraphs 7.1 and 7.2, and where compensation must be paid as described in section 12 of this standard;**
- **'Constituent Documents' of a Scheme means the rules and regulations under which the Scheme exists;**
- **'Entry Price' means the Scheme price at which an Investor acquires an equitable interest in a Scheme;**
- **'Exit Price' means the Scheme price at which a Scheme Holder realises an interest in the Scheme;**
- **'Interest' means an undivided portion of the equity of a Scheme;**
- **'Investors' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definition';**
- **'IFSA Member' refers to a 'Full Member' as defined in IFSA's Articles of Association;**
- **'Non-Compensatable Event' means a unit pricing error where the impact of the error on the price of a unit is less than the materiality threshold adopted in accordance with paragraphs 7.1 and 7.2;**
- **'Prices', in relation to a Scheme, together mean the Entry Price and the Exit Price of that Scheme;**
- **'Scheme' has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions';**
- **'Scheme Assets' means the assets and liabilities of the Scheme, the valuation of which is determined in accordance with IFSA Standard No.9.00 'Valuation of Scheme Assets and Liabilities; and**
- **'Scheme Operator', in relation to a Scheme, has the same meaning as in IFSA Guidance Note No. 5.00 'Industry Terms and Definitions'.**

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9 Principles for the Assessment and Compensation of Errors in the Pricing of Scheme Units

9.1 A Scheme Operator's processes for the assessment and compensation of errors in the pricing of scheme units must meet the following criteria:

- **they must be documented and transparent.**
- **they must individually rectify past and present Investors that have been affected by a materially incorrect unit price.**
- **they must consider the obligations of Scheme Operators under relevant legislation.**
- **they must not result in any residual benefit to Scheme Operators.**
- **they must be regularly reviewed.**

9.1.1 This Standard may not cover every situation faced by a Scheme Operator where there has been an incorrect pricing of an interest in a Scheme. Where a situation is not covered, a Scheme Operator should have regard to these principles.

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10 Pricing Controls by Scheme Operators

10.1 It is required that the Scheme Operator complies with all IFSA Standards related to the valuation of scheme assets and liabilities and scheme pricing, in particular IFSA Standard No. 9.00 'Valuation of Scheme Assets and Liabilities' and IFSA Standard No. 8.00 'Scheme Pricing'.

10.1.1 Legislative and fiduciary responsibilities require Operators to operate a Scheme in a professional manner for the benefit of Scheme Investors.

10.1.2 These responsibilities include having adequate controls and systems in place to ensure that all elements of the valuation of Scheme assets and pricing of Scheme interests functions are conducted in an accurate, timely and consistent manner. Adequate documentation regarding source data, calculations and outputs must be maintained. Scheme Operators must also ensure that outputs from the valuation and pricing functions are monitored, with appropriate indicators and benchmarks in place which will signal any possible errors.

10.1.3 Where the pricing function is delegated to a third party ("the pricing agent"), the Scheme Operator will need to satisfy itself that the pricing agent's systems are robust and will procure accurate results. The Scheme Operator must continuously review the outputs from the pricing agent to satisfy itself that the pricing agent remains competent to carry out the function, and that it has taken reasonable care to ensure that the pricing agent has carried out its duties in a competent manner.

11 Documented and Transparent Assessment and Compensation of Errors in the Pricing of Scheme Units

11.1 IFSA Members must have a policy framework in place that documents the adoption of the Principles for the Assessment and Compensation of Errors in the Pricing of Scheme Units. The policy framework must include, at a minimum:

- **Delegated authorities for policy approval;**
- **Reporting requirements;**
- **Processes to confirm the completeness of and compliance with policies;**
- **Training requirements for policy awareness;**
- **The alignment of procedures to policies;**
- **Ongoing review of policies and procedures; and**
- **Outsourcing arrangements (where appropriate).**

11.2 The Scheme Operator's policies governing the assessment and management of errors in the pricing of scheme units must, at a minimum, include documentation of:

- **The Scheme Operator's definition of what constitutes an error in unit pricing.**
- **The principles adopted by the Scheme Operator in assessing and rectifying errors in unit prices.**
- **Error notification, recording and reporting protocols.**

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- **Delegated authorities and approvals for compensation payments.**
- **The size of, and basis used to determine, any materiality thresholds used in assessing errors in Scheme unit prices.**
- **Communication protocols regarding errors in Scheme unit prices to Investors and regulators.**

11.3 A Scheme Operator's error assessment process will include a determination of whether an error is a Compensatable Error or a Non-Compensatable Event, based on the materiality thresholds adopted in accordance with paragraphs 7.1 and 7.2 (also refer to Appendix 1 of this Standard).

11.3.1 From time to time, adjustments may need to be made to unit prices as a result of approximations or estimates being updated to actual figures as they become known, or due to a change in methodology or policy. Such an adjustment is not considered to be an error under this Standard where the adjustment to unit prices occurs as a result of the consistent application of sound policy. Conversely, if policy or estimates are found to be inappropriate, or application of policy has been deficient, adjustments to unit prices may be errors requiring compensation.

11.3.2 An example of a decision tree that may be used to differentiate between unit pricing adjustments, Compensatable Errors, and Non-Compensatable Events is included as an appendix to this Standard.

11.3.3 Scheme Operators may disclose information to Investors about how errors in Scheme unit prices would be assessed and managed in the event that they occur, including information about materiality thresholds that may be adopted in the error assessment and compensation process.

11.4 Errors must be reported to the appropriate level of management within the Scheme Operator. All errors must be recorded and action taken to minimise the risk of recurrence.

11.5 When an error in unit pricing occurs and compensation is payable to past and/or present Investors, the Scheme Operator must make reasonable efforts to communicate to affected Investors and describe the nature of the error, how the error will be rectified, and how the affected Investor will be compensated for the error.

12 Compensation of Errors in the Pricing of Scheme Units

12.1 Where a Compensatable Error has been identified, compensation to or from past and/or present Investors or the Scheme will be required where the Investors or the Scheme have been disadvantaged as a result of the Compensatable Error.

12.1.1 Where an application or redemption has taken place at a price which is incorrect by more than the materiality threshold adopted under paragraph 7.1, it is required that the Scheme and/or Investor be compensated to the extent that they have been disadvantaged.

12.1.2 The Scheme Operator may choose to recover amounts from Investors who have been advantaged by a Compensatable Error.

12.1.3 The Scheme Operator may conclude that an effective means of compensation is to re-book applicable transactions using the correct unit price. In doing this, Scheme Operators should

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have appropriate regard to any backdating implications of these amended entries, and should consult IFSA Standard No. 8.00 “Scheme Pricing” for further guidance.

12.1.4 Where there is more than one factor at any one time which causes an incorrect price to be calculated, compensation will be required whenever, and so long as, the combined effect on any one day results in a Compensatable Error.

12.2 Under certain circumstances, Scheme Operators may elect to set a minimum dollar compensation amount before compensation will be paid to an individual Investor. Where such a threshold is adopted, the maximum amount of such a threshold is $20.

12.2.1 In choosing whether to adopt a threshold for compensation payments, the Scheme Operator must consider:

- Legislative obligations.
- The possible effects on Investors in the Scheme of costs associated with the payment of small amounts of compensation.
- The obligations of the Scheme’s Constituent Documents.

12.2.2 Where a dollar materiality threshold is adopted, the Scheme Operator must consider the treatment of amounts below the threshold, taking into account the Scheme Operator’s legislative obligations.

12.3 Where a Non-Compensatable Event has occurred, consideration must be given to whether any further action is required to correct the pricing of the Scheme.

12.3.1 Examples of further action that may need to be taken could include (but is not limited to) processing a transfer of funds between investment options in a superannuation fund, adjustment of an accrual within a unit price, or adjustment of a tax provision.

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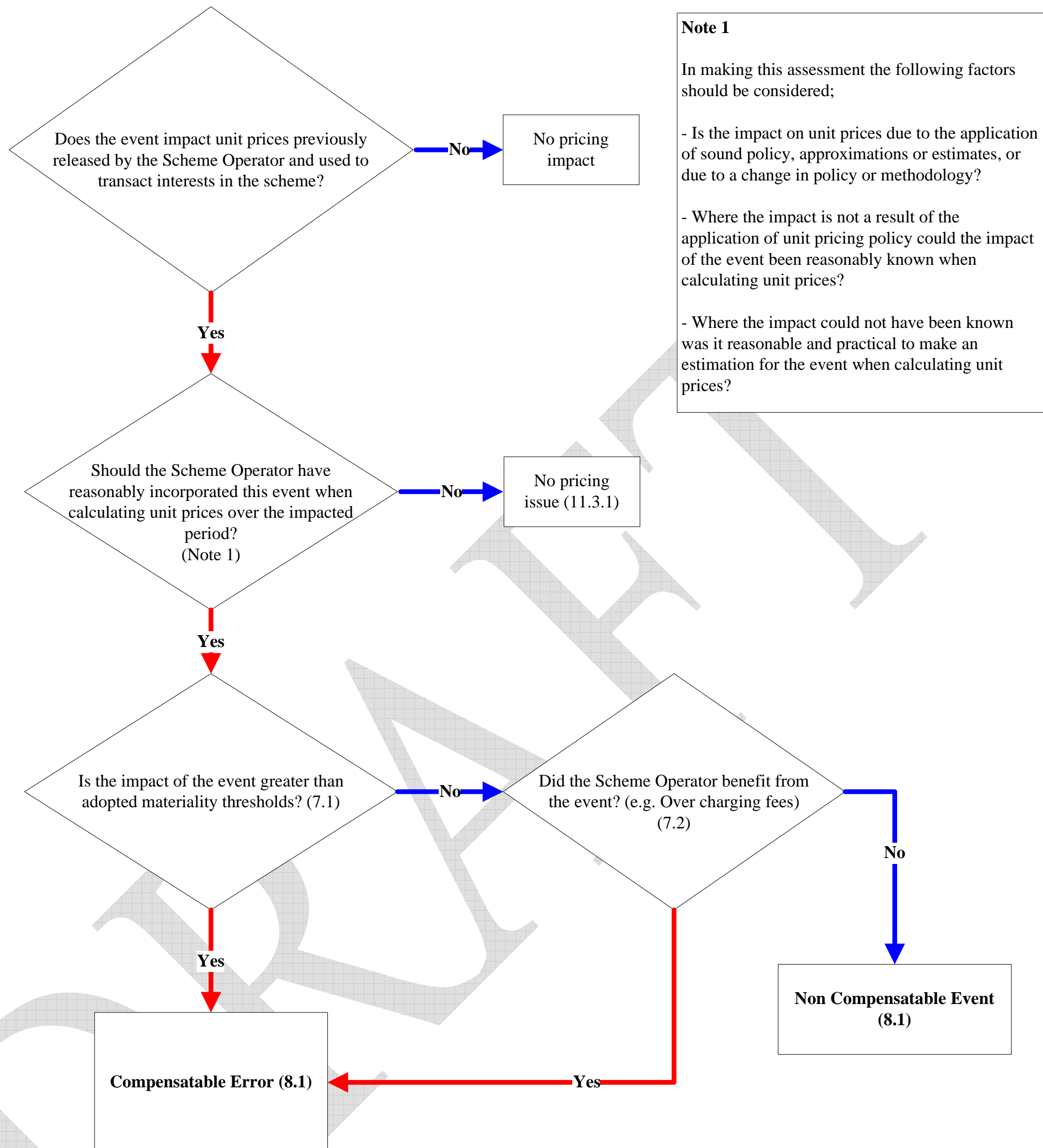
Appendix 1



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