



Investment & Financial Services Association Ltd

**IFSA Submission**

**20 September 2007**

**PRODUCT RATIONALISATION –  
ISSUES PAPER**

## TERMS USED

For the purposes of this submission, the following terms mean:

**‘Customer’** includes the beneficiaries of superannuation entities, members of managed investment schemes, and life investment and life risk policy holders.

**‘Financial product’** or **‘Product’** means a financial product within the meaning of Division 3 of Chapter 7 of the *Corporations Act 2001*, and includes a sub-plan of a superannuation fund, a class of interests in a managed investment scheme, and life policies on the same terms in a statutory fund of a life insurance company.

**‘Interests’** means:

(a) for the trustee of a superannuation entity or the responsible entity of a registered scheme or trustee of a wholesale scheme, “best interests” which under trust law, Commonwealth law and State trustee legislation includes the obligations to:

- act honestly and to exercise powers for their proper purposes;
- not to act for their own benefit;
- act in good faith; and
- treat customers of the same class equally; and

(b) for a life insurance company, a common law and statutory obligation of utmost good faith and a statutory obligation to give priority to costumers’ interests.

**‘Operator’** includes:

- the trustee of a superannuation entity;
- the responsible entity of a registered managed investment scheme;
- the trustee of a wholesale managed investment scheme;
- a life insurance company offering insurance.

In each case, either by operation of common law or by statute (or both), the Operator must act in the ‘interests’ of its customers.<sup>1</sup>

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<sup>1</sup> Under trust law, the *Corporations Act 2001* and the *Superannuation Industry (Supervision) Act 1993*, the trustee must act in the “best interests” of customers. Under the *Insurance Contracts Act 1984* each party to a contract of insurance is by law subject to a contractual obligation of utmost good faith. Under the *Life Act 1975* the insurer must give priority to customers interests.

The following discussion addresses each of the Questions asked in the Product Rationalisation – Issues Paper released on 22 June 2007.

## AVAILABILITY

1	Should product rationalisation be limited to a one off opportunity or should it be available on an ongoing basis? What are the reasons for your views?
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### Issue

Is the need for financial product rationalisation to be available on an ongoing basis?

### Discussion

A single permanent product rationalisation facility in the law for superannuation, managed investment, life insurance and life risk financial products is required to accommodate the ongoing evolution of the financial services industry, product development and to enable the Operator to act in the interests of, or give priority to, their customers.

Consistent with the significant changes made under the Financial Services Reforms, we recommend that this facility be placed in the Corporations Act. It is our recommendation that this new facility be introduced in addition to the existing legislative mechanisms for the winding up or transfer of funds or businesses in the *Corporations Act 2001*, *Superannuation Industry (Supervision) Act 1993* and *Life Insurance Act 1995*.

The issues surrounding the need for a product rationalisation mechanism are not one off issues and will continue to affect industry (e.g., product development and innovation, technological development, legislative changes, etc). Subject to certain customer protections and safeguards, business should have the opportunity to respond to these developments and changes as the need arises and as opportunities present themselves.

Technological advances and competitive pressures, both domestically and globally, underpin the dynamic nature of the Australian financial services industry. The increased sophistication of technology systems and changes in customer preferences and demands will, when combined with changes to the law and its administration, inevitably mean that financial products and systems will from time to time become isolated and effectively made redundant. The law needs to accommodate a process to rationalise redundant financial products on an ongoing basis.

### Recommendation

Legislation to facilitate product rationalisation must be a permanent feature for financial services regulation. Product rationalisation should be available on an ongoing basis.

## THRESHOLD REQUIREMENTS

2	Should there be threshold requirements limiting which products may be rationalised? If yes, what should these requirements be, and why do you think they are justified? Is it necessary to specify which product providers and product types are to be included? If yes, which ones should be included or excluded, and for what reasons?
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### Issues

Should there be limits on what can qualify for financial product rationalisation?

### Discussion

Financial products to which this rationalisation proposal is primarily directed are managed investment schemes, superannuation entities (ie superannuation funds, approved deposit funds and pool superannuation trusts) and life insurance investment and risk products.

The IFSA 2005 submission referred to “legacy products” and “legacy systems”. A legacy product need not be underpinned by a legacy system and, therefore, the categorisation of a financial product as redundant should not be a system based definition.

We note that the moves in the European Union to facilitate the cross border merger of UCITS are primarily based on the issue of the economics of fund efficiency and size (see Commission of the European Communities, **White Paper on Enhancing the Single Market Framework for Investment Funds**, Brussels, 15 November 2006). The same issues are equally as important in the operation of the Australian financial system. The need for the rationalisation of a financial product should be based on the Operator’s assessment of the risks and efficiency of the financial product and the overall interests of customers participating in the product.

A range of commercial drivers may exist for the termination of a financial product. To the extent that a customer is no worse off, product rationalisation, where it is offered to customers should not be subject to threshold requirements. Certainly, financial products suitable for rationalisation should include financial products that:

- are administered on old technology platforms that represent a serious maintenance risk but that cannot be moved because they cannot be accommodated on another platform;
- have not achieved or maintained the necessary scale to be economically viable; or
- have been acquired due to an acquisition or merger, and which are duplicated elsewhere in the Operator’s suite of products.

Financial products include managed investment schemes, superannuation funds, approved deposit funds, pooled superannuation trusts, retirement savings accounts and life insurance products.

### Recommendation:

IFSA recommends that the proposed product rationalisation facility is made available where:

- the Operator holds an Australian Financial Services Licence (**AFSL**) or carries on a financial services business and is exempt from the requirement to hold an AFSL; and
- the class of product is closed, or intended to be closed before the rationalisation, to new customers.

3 Should beneficiaries have the right to object to product rationalisation proposals? If so, what special measures should apply if objections exceed a certain critical level and what should the critical level be?

### **Issue**

Should an individual be able to stop a proposed product rationalisation?

### **Discussion**

Customers should not have the ability to stop a product rationalisation.

Customers should have the right, however, to make a complaint in accordance with complaint mechanisms currently available to customers in the financial services industry (e.g., Financial Industry Complaints Service (**FICS**) or Superannuation Complaints Tribunal (**SCT**)) where they have or will suffer a financial loss. This may necessitate some minor amendments to the jurisdiction of, and types of claims that can be determined by, such External Dispute Resolution (**EDR**) schemes. For example, the SCT is currently unable to hear and determine a complaint that relates to a decision about the whole of a superannuation fund. The same restriction applies to FICS. Further, the FICS claim limits may allow an Operator to rationalise some products and leverage off the fact that the amount of a claim or claims would be less than the cost savings of the rationalisation.

Responsibility for the initiation and conduct of a proposed product rationalisation will rest with the Operator. The Operator rationalising a product should have regard to the interests of the class of customers as a whole, and ensure that they can be moved from a legacy product to a more suitable financial product or products without a material adverse financial detriment. Any particular person who is actually worse off in a more than trivial way as a result of this action should have a right to complain to the Operator and to seek compensation.

### **Recommendation**

Customers should not have the right to stop a product rationalisation. We support a right of complaint, and a right to seek compensation, but not a right to prevent a rationalisation.

4 Which parties should have the right to bring forward product rationalisation proposals?

### **Issue**

Who should be entitled to initiate a product rationalisation?

## **Discussion**

Responsibility for a product rationalisation should always be with the Operator only. The decision to rationalise a product should be primarily based on the ability of an Operator to continue to support the relevant financial product and the continued economic viability of the product. It should be noted that the requirement to act in the interests of customers is paramount.

## **Recommendation:**

The Operator should be the only party that can initiate a product rationalisation.

## **COMPULSORY TRANSFER OF BENEFICIARIES**

5	Should compulsory transfer of beneficiaries be a part of a product rationalisation mechanism?
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## **Issue**

Can product rationalisation be effected without compulsory transfer of customers?

## **Discussion**

Requiring customer 'consent' could effectively mean that even a single customer may potentially be able to prevent rationalisation despite the fact that it would be in the interests of the class of customers as a whole for the proposal to proceed.

The recommended inclusion of customer protection mechanisms as part of the product rationalisation process (i.e., equivalent benefits, and compensation mechanism, etc) should ensure that customers are not materially adversely affected by any such process. This is similar to the approach currently used in the successor fund provisions where the transfer mechanism has been effective.

Experience has shown that in the absence of compulsory transfer, it is unlikely that product rationalisation will proceed.

## **Recommendation**

Product rationalisation should involve the compulsory transfer of customers to another financial product or products, or the termination of their interest in the rationalised product without transfer.

6	If not, how would you address the issue of a small remnant of beneficiaries, for instance in a life insurance product, refusing to consent to a rationalisation proposal and thereby preventing the realisation of the benefits of the proposal?
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### **Issue**

Will product rationalisation proceed without compulsory transfer?

### **Discussion**

It is unlikely that product rationalisation would be successful in the absence of a compulsory element. Without compulsion an individual or small group could effectively prevent the rationalisation of a financial product contrary to the interests as a whole of that class of customer holding the product.

### **Recommendation**

Product rationalisation should involve the compulsory transfer of customers to another financial product or products, or the termination of their interest in the rationalised product without transfer.

## **EQUIVALENT RIGHTS AND BENEFITS TEST — CONTENTS**

7	Should the legislation itself contain a detailed test? If so, what should the contents of the test be?
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### **Issue**

In assessing what is in the interests of its customers, what test or benchmark should the Operator apply?

### **Discussion**

A detailed test may prevent product rationalisation in legitimate circumstances because the proposal arbitrarily fails some aspect of a detailed test. Because of the complexity of individual financial products and the range of different features and characteristics, a detailed test based on equivalent rights is impractical and may not have regard to the overall benefits accruing to customers from a product rationalisation.

A single test, based on an evaluation that the proposed product rationalisation, will result in at least equivalent benefits to the class of customers as a whole, should be required. The law should contain a principles-based mechanism coupled with the usual disclosure requirements (e.g. a Product Disclosure Statement (**PDS**) for the issue of a financial product, confirmation of transactions and significant event reporting).

In conjunction with any principles-based test, Operators will continue to be subject to existing legal duties that apply to them. For example:

- Responsible entities of registered managed investment schemes would continue to be subject to the duties in section 601FC(1) of the Corporations

Act including the duty to act in the best interests of members and to give priority to member interests over their own (section 601FC(1)(c));

- Trustees of wholesale managed investment schemes will continue to be subject to duties under trust law including the duty to act in the interests of unitholders;
- Trustees of superannuation entities will continue to be subject to fiduciary principles and the specific covenants imposed by section 52(1) of the SIS Act, including the duty to act in the best interests of beneficiaries (section 52(1)(c)); and
- Life insurers would continue to be subject to the duties in the Life Act, including the duty to give priority to the interests of policy owners above the interests of shareholders (section 32 and section 48) and to act with the utmost good faith (section 13, Insurance Contracts Act).

### **Recommendation**

The legislation should be principles based and, a single test applied to the class of customers in the product to be rationalised, should provide that those customers receive benefits that are, as a whole, at least equivalent to benefits enjoyed in the rationalised product. See Question 8 for further detail.

8	If the legislation does not prescribe the test in detail, what high level principles should it contain? Should guidance be provided for each principle? Who should provide this guidance?
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### **Issue**

What principles should be used for the purpose of a product rationalisation?

### **Discussion**

Fundamental principles underpinning any product rationalisation proposal are that:

- the Operator must first determine that the proposed product rationalisation is in the interests of the class customers as a whole and may cover only a class of customers, customers in a sub-plan, or policy holders in a statutory fund;
- the rationalisation must provide, as a whole, at least equivalent benefits to the class of customers effected. The new benefits could be provided by one or more replacement financial products or be combined with financial compensation.;
- if an individual suffers a material financial detriment, that customer has a right to seek compensation.

We recommend that a Regulatory Guidance should be prepared, in consultation with industry bodies, on the application of the principles underpinning product rationalisation. Primary regulators would be ASIC and APRA, and to the extent that taxation issues are involved, the Australian Taxation Office.

## **Recommendation**

Prescribed principles should be limited to the core concerns of a product rationalisation.

9	How should the test be applied to beneficiaries? Do you think it is feasible to require analysis of each beneficiary and their circumstances? How should product providers demonstrate that the no detriment test has been satisfied?
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## **Issue**

Should the benefit test be applied on an individual basis or on a class basis?

## **Discussion**

The equivalent benefits test should be applied as a whole to customers on a group or class basis. A requirement for the Operator to consider the individual circumstances of customers is unrealistic and impractical. Individuals who do suffer a material detriment will have a right to seek adequate compensation.

As stated by APRA before the Senate Legislation Economics (2 November 2005) “At the end of the day, the trustee looks at the interests of the members as a whole, not each and every individual member”.

## **Recommendation**

The equivalent benefits test should be applied to the customers in a financial product:

- holding a class of interests in a managed investment scheme;
- in a sub-plan of a superannuation fund; or
- as policy holders of a statutory fund.

## **EQUIVALENT RIGHTS AND BENEFITS TEST — PROCEDURES**

10	Which entity should be responsible for applying the equivalent rights and benefits test? Should there be more than one entity involved? If so, what would the difference in responsibilities be among the entities involved?
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## **Issue**

Who should be responsible for the equivalent benefits test? The transferor entity or the transferee entity?

## Discussion

The Operator should be responsible for the product rationalisation and transfer of customers. As stated above at Question 7, Operators will continue to be subject to existing legal duties that apply to them. For example:

- Responsible entities would continue to be subject to the duties in section 601FC(1) of the Corporations Act and trust law, including the duty to act in the interests of members and to give priority to member interests over their own (section 601FC(1)(c));
- Trustees of wholesale managed investment schemes will continue to be subject to duties under trust law including the duty to act in the interests of unitholders.
- Trustees of superannuation entities will continue to be subject to fiduciary duties and the specific covenants imposed by section 52(1) of the SIS Act, including the duty to act in the interests of customers (section 52(1)(c)); and
- Life insurers would continue to be subject to the duties in the Life Act, including the duty to give priority to the interests of policy owners above the interests of shareholders (section 32 and section 48) and to act with the utmost good faith (section 13, Insurance Contracts Act)..

Regulatory approval or approval by another external body should not be required. It should be sufficient for an Operator to apply the equivalent benefits test in conjunction with regulatory guidance and existing legal duties to act in the interests of customers.

## Recommendation

The Operator should be responsible for applying the equivalent benefits test.

11	What rules should apply to the procedures of the approving entity and what should the scope of its powers be?
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## Issue

Should procedures be prescribed up to and including the decision to rationalise a financial product?

## Discussion

A product rationalisation mechanism should not be subject to any external approval requirement (i.e. approval by ASIC or APRA). The Operator proposing a rationalisation should undertake a four step process of:

1. **Assessment** – The Operator should fully document its assessment, key assumptions and the proposed structure for the transfer of customers;

2. **Verification** – The Operator will need to be satisfied that the class of customers transferring from the rationalised product will receive equivalent benefits;
3. **Pre-rationalisation disclosure** – Customers must be advised of the proposed rationalisation, their individual right to complain and to seek compensation, and the process for the rationalisation; and
4. **Post Rationalisation disclosure** – Confirmation of the rationalisation should be provided to customers who should also be provided with a statement of their new interests.

Product rationalisation would be subject to the existing internal dispute resolution and external dispute resolution arrangements that apply to Operators. No other procedural requirements should be imposed. Operators are subject to legal requirements to act in the interests of their customers (see Questions 7 and 10 above). For the purpose of satisfying itself that the basis product rationalisation satisfies the test or is in the ‘interests’ of its customers, an Operator may engage external experts such as lawyers, accountants, actuaries or auditors, but should not be required to do so. This approach recognises the primary responsibility and accountability of the Operator for a product rationalisation.

### **Recommendation**

The Operator must act in the ‘interests’ of customers as a whole. No procedural requirements other than the process identified above should be required.

12 Should the regulators have a special role in the approval process? If yes, what should this role be? Is there a case for making a distinction between the regulators, given their different responsibilities?

### **Issue**

What role should the regulators play?

### **Discussion**

Regulators should not have any approval power. Regulators should continue to maintain their general supervisory powers and responsibilities, which would include supervision of the Operator in a proposed product rationalisation.

### **Recommendation**

The regulators should not have a specific role in the approval process but can clearly continue to exercise their general supervisory powers in relation to a proposed product rationalisation.

13 Can there be a single process covering all types of products? If yes, how should the differences be addressed? If no, what separate processes should there be and in what respects should they be differentiated?

**Issue**

Should there be a single legislative platform for product rationalisation?

**Discussion**

A single legislative mechanism to enable Operators to rationalise their operations to more efficiently meet the needs of customers should be introduced to facilitate a legislative neutral mechanism for financial product rationalisation.

The Financial Services Reform legislation was designed to better protect investors and equip the Australian financial services industry to compete in the 21<sup>st</sup> century. While the superannuation and life insurance industries provide a specified scope for financial product rationalisation under existing laws, those facilities has been inadequate to generally meet the challenges of a dynamic industry. It is our recommendation that these existing mechanisms should continue to be available in addition to the proposed new product rationalisation mechanism.

To the extent that there are differences in the classes of financial product being rationalised, regulations could specify any specific issues for consideration. The actual process that a Operator may go through may differ depending on the type of product, but the principle of equivalent benefits and customer outcomes should remain unchanged. That is, the customer should have at least equivalent benefits and a right to seek compensation for any materially adverse financial loss.

**Recommendation**

A single legislative platform for financial product rationalisation should be introduced into the Corporations Act with differences in treatment between product types specified in the regulations.

**TAXATION**

14 Do you agree with the issues as outlined above and with the general approaches proposed to address them? If not, why not? Are there other ways to achieve the intended outcomes?

**Issue**

Taxation

**Discussion**

Where the transfer of customer interests and underlying assets from the rationalised product to another product does not change the beneficial ownership, the transfer should be tax

neutral. While the formal mechanics of rationalisation will vary from product type to product type, the following four fundamental attributes are necessary:

- the change of the investor's interest from ownership in rationalised product to the product(s) to which customer interests are transferred must be tax neutral for the customer;
- the transfer of any underlying assets from rationalised product to the product(s) to which customer interests are transferred must not give rise to an immediate tax liability;
- any tax attributes of rationalised product need to be carried over to the product(s) to which customer interests are transferred (examples of this are the 45 day holding period for imputation credits and the ten year rule for Life insurance Bonds).
- State Stamp Duty Laws need to be amended so that rationalisation does not trigger exposure to stamp duty. Such relief was provided previously for transitions to implement the Managed Investments Scheme regime.

Please see **Appendix A** for recommended tax changes.

### **Recommendation**

We recommend that the Income Tax laws and Stamp Duty laws be amended to provide tax neutrality where product rationalisation has been undertaken.

15	Are there other tax issues that should be considered? What are they, why are they important in this context and how do you think they could be addressed?
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See Item 14 above

### **DISCLOSURE**

16	With respect to pre rationalisation disclosure, what information would need to be given to beneficiaries? Should the disclosure documentation need approval, for example by the regulator? Should the regulator or other approving entity be able to impose special requirements in individual cases?
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### **Issues**

- a) Content of pre rationalisation disclosure; and
- b) Approval of disclosure.

### **Discussion**

(a) The existing disclosure provisions of the Corporations Act are adequate to cover disclosure obligations in the event of product rationalisation. That is, customers would

continue to receive the product disclosure required by Pt 7.9 of the Corporations Act. This includes:

1. Significant event reporting (section 1017B) – proposed product rationalisation should be prescribed as a specified event pursuant to section 1017B(1A)(b) of the Act..
2. The notification to members should contain information explaining:
  - the reasons for the proposed product rationalisation;
  - the process and schedule for the rationalisation;
  - the rights of customers;
  - the options available to customers; and
  - the consequences of exercising those options including a right to complain.
3. Confirmation of transactions (section 1017F).
4. Product Disclosure Statement for the issuer of a financial product to which customers are to be transferred.

The decision to rationalise a financial product is a commercial decision taken in the interests of customers. Approval of disclosure by the regulator/s should not be required. The regulators would continue to have their normal powers to intervene and ask for documents under notice.

### **Recommendation**

There should be mandated disclosure. The role of the regulators should be limited to their existing supervisory responsibilities.

17 If a right to object is included, how much time should beneficiaries be given to respond? Is there a need for special rules to apply if beneficiaries do not respond?

### **Issue**

Should customers have a right to object?

### **Discussion**

See Item 3 above. Customers should not have the right to stop a product rationalisation. We support a right of complaint and a right to seek compensation, but not a right of objection. A right to object (as opposed to complain) should not be included in any product rationalisation mechanism. See Question 20 for further detail.

A customer will have the right to exit a financial product before rationalisation. Customers in a product rationalisation will be transferred as a whole to the designated transferee product(s).

The lack of a response from a customer will not affect the transfer and that customer retains the right to complain, to seek compensation, and to exit the new product(s).

### **Recommendation**

Customers should have a right to complain but not a right of objection.

18 What procedures should apply in the case of lost beneficiaries? Should they be automatically transferred to the new product? If yes, what conditions should apply? If not, what should be done with their investments?
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### **Issue**

How will lost customers be dealt with?

### **Discussion**

Existing arrangements for dealing with lost members and unclaimed monies are sufficient and should continue to apply in the context of any product rationalisation process.

Operators should be able to transfer lost customers (including their investments) and as part of a product rationalisation mechanism.

### **Recommendation**

There should be no change to the existing requirements for dealing with lost customers.

19 As regards post rationalisation disclosure, should there be any special requirements other than notification of new allocations?
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### **Issue**

Is there a need to mandate post rationalisation information to customers?

### **Discussion**

Pre-product rationalisation disclosure should be sufficient disclosure to customers see response to Question 15. Post rationalisation, the customer should be in receipt of the normal ongoing disclosure for that financial product. Post rationalisation, the former product will cease and that particular relationship is terminated.

### **Recommendation**

There is no need for mandated post rationalisation disclosure.

## COMPLAINT AND COMPENSATION MECHANISM

20 Can one entity cover complaints and compensation regarding all products, or is more than one required? If one entity only, which entity would you suggest? If more than one, which ones would you suggest and how should their functions be separated?

### Issue

Are the existing external dispute resolution (**EDR**) arrangements sufficient?

### Discussion

It is not necessary to establish a new body or bodies to determine claims and complaints by customers as a result of a product rationalisation. Subject to some amendments to their jurisdiction etc, existing EDR schemes would be the appropriate bodies to determine claims and complaints. Another external complaints body would add more red tape, cost and complexity to the regime.

Customers should have the right to make a complaint to one of the existing EDR schemes where compensation is in issue. It may be necessary to review the existing jurisdictional restrictions. For example, the jurisdiction of the SCT would need to be amended so that it could hear complaints relating to product rationalisation transfers even though these are decisions that relate to the management of a fund as a whole (currently excluded by s14(6) of the SRC Act). Likewise, the FICS “fund as a whole” restriction would need to be reviewed for complaints relating to a product rationalisation transfer.

### Recommendation

The existing EDR bodies are sufficient to deal with complaints relation to disputes over compensation arising from a product rationalisation. The jurisdiction of the relevant EDR bodies should be reviewed to ensure that such complaints adjudicated by the relevant EDR scheme.

21 What process and timeframes should apply to applications to this body? Should there be a time limit within which claims can be brought forward?

No comment. Subject to minor changes to their jurisdiction etc, existing EDR schemes should be sufficient to determine complaints with respect to product rationalisation processes, following completion of the rationalisation event.

22 What is the appropriate scope of the claims and complaints the scheme may hear? Should it be limited to assessing claims for monetary compensation? If the scheme may determine compensation amounts, should it be subject to some sort of cap? If the scope of the mechanism were wider than monetary compensation, what types of remedies should the scheme be able to impose? How long should the right to claim compensation endure after the product rationalisation has occurred?

### **Issue**

What jurisdictional limits should apply to EDR schemes in relation to product rationalisation?

### **Discussion**

EDR schemes should be permitted to adjudicate the quantum of the compensation amount where a customer has sought compensation for a financial loss suffered as a result of the termination of the rationalised product and transfer to another financial product(s). That compensation amount is based on an assessment of the loss of benefit suffered by an individual as a direct result of the transfer. Loss of benefit should not take into account consequential losses.

A claim for compensation in relation to a rationalisation will be based on the quantum of the amount, if any, offered. The claimed loss of benefit should be:

- quantifiable in financial terms; and
- be specific damages and not general damages (this is for constitutional reasons).

### **Recommendation**

EDR arrangements should consider only the quantum of compensation offered in relation to an actual loss of benefit suffered as a consequence of the product rationalisation. Such loss should be a direct loss and not consequential losses (eg taxation).

23 Who should bear the costs associated with the operation of the entity and the compensation awards? Should it be the product providers, the schemes or funds, or should there be some measure of sharing, and if so what should it be? Alternative arrangements are also conceivable, for example a compensation pool funded by the industry. Is this or some other arrangement a preferable solution? If so, what should it be and how should it operate?

### **Issue**

How should a product rationalisation, and potential compensation awards, be funded?

## **Discussion**

Equivalent benefits are a matter for the Operator to determine and hence both the assessment of any costs and assessment of entitlement to compensation is a matter for the Operator initiating the product rationalisation. There should not be any industry cross subsidisation of product rationalisation.

Existing arrangements for the funding of EDR schemes should continue to apply.

## **Recommendation**

Compensation should be paid by the Operator and not from the relevant fund. See Question 24 below in relation to operational costs.

## **ALLOCATION OF COSTS AND BENEFITS**

24 Which parties should bear or enjoy the costs and benefits arising out of product rationalisation transfers? Should they be attributable solely to product providers and their shareholders, or should there be some sharing between shareholders and beneficiaries? If so, how could these costs and benefits be calculated?

## **Issue**

Who should bear the costs of a product rationalisation?

## **Discussion**

Other than costs that would otherwise be reimbursable to the Operator in the normal course of the management of the financial product, the costs of a proposed product rationalisation should be borne by the Operator and not by the customers or relevant fund.

Typical product rationalisation costs incurred by the Operator will include:

- preparation and assessment of the product rationalisation proposal;
- external advisory costs in relation to the proposal;
- assessment of compensation payable, if any;
- communication with customers for the product rationalisation;
- any dealings with the Regulator in relation to a product rationalisation.

## **Recommendation**

The Operator should bear the direct costs of a product rationalisation.

## EXIT FEES

25	Should there be a special mechanism for resolving the problem of high exit fees? If so, what should it be?
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### Issue

How should exit fees be treated as part of a product rationalisation?

### Discussion

'Exit fees' are, where applicable, simply another matter to be taken into account by the Operator in determining whether:

- a financial product should be rationalised;
- the class of customer will receive equivalent benefits in the 'new' product; and
- individual will suffer a materially adverse financial detriment as a consequence of the rationalisation and the transfer to a new financial product..

The term 'exit fee' is often quoted inappropriately to imply that these fees are penalties charged by Operators against the clients who withdraw from the financial product within a specified term. Some commentators imply that customers who exercise this freedom of choice are penalised by fees charged by these Operators.

It should be noted that if an Exit Fee was a penalty, rather than a genuine pre-assessment of loss, it may be unenforceable under the common law Penalty Doctrine.

"If the agreed damages were not a genuine pre-estimate then the court deems the clause penal and will strike it down and substitute its own assessment of damages" – (see *Economists Divided - Different Perceptions of Contracts Penalty Doctrine* by Jeremy Thorpe, Economist, Office of Regulation Review Industry Commission (Canberra) in *Bond Law Review*, Vol 6 Issue 2 1994).

IFSA believes that most so called 'exit fees' are not any form of penalty. The ASIC web site carries a description of 'exit fees' and makes the point that 'long expiry exit fees' are simply a bringing forward of the ongoing contractual fees that have been calculated by reference to the contractual term.

### Recommendation

No special mechanism is required to deal with 'exit fees'. The matter should be considered in the overall context of the Operators assessment of the customer benefits.

26 Alternatively should exit fees be addressed as part of the equivalence test?

**Issue**

Are 'exit fees' part of the equivalence test?

**Discussion**

Exit fees should be considered, like any other product feature, as part of any equivalent benefits test.

**Recommendation**

Exit fees should be addressed by the Operator in its assessment and application of equivalent customer benefits in the product to which the customer is transferred.

**ONGOING MINIMISATION OF LEGACY PRODUCTS**

27 Do you think that regulatory action is required to achieve a reduction in the rate of creation of legacy products, and if so what specific measures would have to be adopted?

**Issue**

Can the creation of legacy products be avoided?

**Discussion**

A legacy product is never created, it evolves. That evolution may be the outcome of customer demand, technological or legislative changes.

The inclusion of a mandatory covenant in trust deeds, scheme constitutions or insurance contracts, that the arrangement can be unilaterally terminated by the Operator where specified thresholds and redundancy is reached would put customers on notice of a possibility at some time of product rationalisation of the financial product. This, however, would not address the taxation consequence of termination of a legacy product.

Legislative reform introducing a single rationalisation mechanism is, we believe, the only appropriate means of addressing the economic and systemic issues inherent in legacy products.

**Recommendation**

The introduction of a product rationalisation regime consistent with Option 3 of the Issues Paper is the only viable way to address the issue of legacy products.

28 What action do you think that businesses could take to reduce the rate of creation of legacy products, thereby lessening the need for government intervention? What measures could be taken to encourage businesses to adopt such practices?

**Issue**

Can the Financial Services Industry address the creation of legacy products without legislative assistance?

**Discussion**

The only method that could be introduced would be to include a mandatory covenant in trust deeds, scheme constitutions or insurance contracts, that the arrangement can be unilaterally terminated by the Operator where specified thresholds are reached, or not maintained. The rights and benefits of individual customers would be determined at the date of termination of the financial product in accordance with the terms of the constituting document or contract..

**Recommendation**

The introduction of a product rationalisation regime consistent with Option 3 of the Issues Paper is the only viable way to address the issue of legacy products.

**EXISTING BENEFICIARIES**

29 Do you think that beneficiaries of existing managed funds into which beneficiaries of legacy products are transferred require special protection measures?

**Issue**

How will the 'to fund' customers be effected by a transfer from a rationalised product.

**Discussion**

It is a matter for the Operator considering a product rationalisation to make an assessment of the financial product to which customers are to be transferred. In the absence of any operational capacity issues in the 'to fund' there should not be a need for additional protection of existing beneficiaries.

The responsible entity of a managed investment scheme is required under the Corporations Act to act in the interests of members and to treat the members who hold interests in the same class equally and members who hold interests in different classes fairly (sections 601FC(1)c) and (d)). The existing legal requirements are, therefore, sufficient.

It could be expected that a 'to fund' would benefit from economies of scale.

**Recommendation**

Existing beneficiaries of a 'to fund' do not require additional protection.

## **PARTICIPATING POLICIES**

30 What are the specific problems posed by participating policies, and how should they be addressed?

### **Issue**

Do participating policies present any specific challenges?

### **Discussion**

Product rationalisation involving participating policies would be subject to the same principles-based test as for any other financial product. The fact that a beneficiary has a right to participate in profits or surplus of a life company would be just another factor that the Operator would need to consider in carrying out any rationalisation of such products.

Operators would need to undertake an assessment of the risks and prudential issues relevant to participating policies based on actuarial advice. However, a prudent Operator applying a principles-based test is likely to do this anyway.

### **Recommendation**

To the extent that types of financial products have characteristics that require specific action, such requirements should be included in regulations supplementing the uniform product rationalisation legislative facility.

## **OTHER ISSUES**

31 Are there any other issues that need to be considered? How should they be addressed?

### *Social Security*

The transfer a customer for one product to another should not have a negative effect for the customer under relevant legislation. Take as an example, an annuity that is 100% or 50% assets test exempt for the purposes of Centrelink and Department of Veteran Affairs benefits because it was purchased before a particular date. If as part of a rationalisation, the customer is transferred to another annuity, the new annuity should retain the status even though the new annuity is issued after the cut off date for the exemption under the Social Security Act. Miscellaneous legislative amendments should be made to ensure that the status of benefits will be grandfathered.

### *Part 9 of the Life Act 1975 – need for amendment*

Use of Part 9 has previously been confined to ensuring the solvency and capital adequacy of statutory funds when a life insurance business has been transferred between companies. A recent Federal Court judgment by Gyles J, Re MetLife Insurance Limited [2007] FCA 1327 resulted in a new class of legacy life policies following an application for transfer of a life business under Part 9 of the *Life Act 1975*.

The decision established a precedent by modifying the proposed scheme to provide an opt out facility that was limited to those MetLife policy holders and beneficiaries who had indicated a substantive objection prior to the hearing. We note that APRA made submissions to the Court cautioning against the opt out mechanism on the grounds that it would create legacy products. APRA also made reference to the Treasury Issues Paper on product rationalisation.

In the context of considering policy issues associated with legacy products consideration should be given to closing down this new Court initiate development by amending the *Life Act 1975* and restricting the discretions available to the Court under Part 9 to avoid the creation of unnecessary legacy products as a result of transfers.

	Rollover relief at the unit/policy holder level	Rollover relief for transfer of the underlying assets (capital and revenue)	Carry forward of accumulated losses/associated deferred tax assets	45 day rule	Components carried forward	Deduction notices	TFN and/or employer declaration forms	No-TFN tax credit	Other
Unit trust	√	√	√ Any capital losses within a unit trust are reflected in the unit price of that trust. Accordingly upon a disposal of units that loss is realised by the investor directly.  [The standard CGT rollover model does not apply in a loss situation].	√ If rollover relief on the transfer of assets is granted, the 45 Day Rule should not apply as no share disposal would occur					
Pensions				√	√		√	√	Deductible amount carry over [for under 60s]  Minimum drawdown carry over so that in the transitional year there is no duplication
Super (including PSTs, ADFs, and RSAs)	√	√	√ Treatment of unrealised losses?	√	√	√ Trustee of the successor fund should be able to accept notices	√	√	

						under 290-170 in respect of contributions made to the former fund (subject to there being sufficient monies held in the successor fund to give effect to the			
Deferred annuities	√	√							Exit of members not treated as a taxable event.
Life company (ordinary)	√	√ Where there is a rationalisation to a unit trust, relief is need.		√					10 year investment rule 125% contributions limit Franking credit carry over for any payout tax credit.
Life company (super)		√	√	√	√		√	√	
Life company (annuities)				√	√ Deductible amount carried over	√	√	√	
Life company (risk)		√							IBNRs or claims to be carried over. Unearned premiums to be carried over

