FSC Guidance Note No. 34

Fees and costs disclosure

31 October 2016

Purpose of this Guidance Note:	To provide industry participants with guidance in relation to the requirements for calculating and disclosing fees and costs in product disclosure statements and periodic statements.
Date of this version:	31 October 2016
History (prior versions) of this Guidance Note:	No prior versions.

Table of Contents

Section of Guidance Note **Page**

1 Title 3

2 Date of Issue 3

3 Statement of Purpose 3

4 Definitions and interpretation 4

5 Background 4

6 Guidance 4

1 Title

This Guidance Note may be cited as FSC Guidance Note No. 34 *Fees and costs disclosure.*

2 Date of Issue

This Guidance Note is dated as at 31 October 2016.

3 Statement of Purpose

3.1 The purpose of this Guidance Note is to assist:

- issuers of certain superannuation products;
- issuers of managed investment schemes issued to retail investors; and
- other relevant industry participants, including platform operators,

with implementation and ongoing compliance with the fees and costs disclosure requirements introduced in Schedule 10 of the Corporations Regulations by ASIC Class Order 14/1252 (**Class Order**) and ASIC's related guidance in updated Regulatory Guide 97: *Disclosing fees and costs in PDSs and periodic statements* (**RG 97**).

3.2 This Guidance Note is not intended to be an exhaustive commentary on fees and costs disclosure requirements. It has been prepared to assist with specific implementation considerations arising from the Class Order and updated RG 97. The contents have been informed with discussions and written feedback from ASIC. Specific comments from ASIC on the proposed final version of this Guidance Note have been used as a basis for the footnotes which have been incorporated for reference purposes.

3.3 The interpretation contained within this Guidance Note does not take into account every scenario concerning fees and costs disclosure and hence consideration should be given to each specific situation. In particular, consideration should be given to a scheme or superannuation fund's constituent documents (*including* the constitution, trust deed and governing rules), and any legislative, regulatory and other applicable obligations or guidelines applicable to the responsible entity, superannuation fund trustee and platform operator (as applicable), as updated from time to time. Consideration should also be given to the interpretation of the fees and costs disclosure requirements in related regulatory guidance, including frequently asked questions (FAQs) released by ASIC from time to time.

3.4 Users must take their own advice and consider their own circumstances. Users of this Guidance Note should not rely solely on this Guidance Note without also assessing the particular factual circumstances applicable to their situation, and also obtaining appropriate advice specific to their circumstances. This document does not constitute any form of advice (including taxation, legal, actuarial, pricing methodology, accounting or other advice) and should not be relied upon as such. Users of this document should take their own advice on legal, taxation, accounting, actuarial, regulatory, and any other relevant matters as appropriate in relation to fees and costs disclosure.

4 Definitions and interpretation

Unless otherwise stated, defined terms have the meanings given to them in the Corporations Act 2001 (Cth).

5 Background

5.1 Schedule 10 of the Corporations Regulations was introduced in 2005 and sets out the requirements for the disclosure of fees and costs of superannuation and managed investment products in PDSs and periodic statements.

5.2 In December 2014, ASIC released the Class Order.

5.3 The Class Order was intended by ASIC to address issues arising from an inconsistent approach to the fee and cost disclosure obligations in PDSs and periodic statements for managed investment and superannuation products. These issues had been earlier highlighted in ASIC's 2014 report into fee and cost disclosure practices (Report 398). In that report, ASIC identified specific issues concerning variations in and under-disclosure of fees and costs, in particular in relation to underlying investment vehicles, performance fee reporting and incorrect treatment of management costs as transaction costs.

5.4 At the time of the release of the Class Order in December 2014, ASIC also announced its review of RG 97 to reflect the effect of the Stronger Super reforms and the Class Order.

5.5 During the course of industry engagement in 2015, ASIC broadened the consultation to accommodate submissions on refinements to the Class Order to address key issues and comments raised by the industry. This process culminated in the release of the updated RG 97 and amendments being made to the Class Order in November 2015.

6 Guidance

6.1 Updating indirect costs disclosure

(a) The Corporations Act 2001 requires a PDS to be up-to-date at all times, and penalties can be imposed if a PDS is misleading or deceptive.

(b) However, except in limited circumstances, disclosures of the following amounts in a PDS for the year in which the PDS is issued (“**Year 1**”) must be based on the financial year prior to issue of the PDS (“**Year 0**”) (clauses 104 and 104A of Schedule 10) [RG 97.29]:

(i) the indirect cost ratio;

(ii) the part of a fee for a MySuper product or investment option of a superannuation entity that relates to costs – whether those costs are incurred by the trustee, interposed vehicle or derivative;

(iii) the part of the management cost of a managed investment scheme that is not a fee payable to the responsible entity.

(c) The obligations on issuers to ensure that PDSs do not become defective and to make reasonably based judgements as to when new costs information comes to their attention needs to be considered both at the start of each new financial year but also in the context of potential fluctuations in costs during the course of each financial year. When new costs information does come to the attention of the product issuer (including information which impacts estimates made in respect of Year 0 costs), this will also need to be assessed on the basis of whether it is materially adverse for the purposes of assessing the availability of the relief in Class Order [CO 03/237] and managing any subsequent reissuing or, where permitted, supplementing of PDSs.

Annual reviews around the end of each financial year

(d) An issuer must consider **around**[1] the end of each financial year whether disclosure for costs in the PDS needs to be updated to ensure the PDS is up-to-date (as required by Section 1012J) and to avoid the PDS being likely to be misleading or deceptive [RG 97.35 - RG 97.40].

(e) Whether or not an issuer will need to update costs disclosed in a PDS will depend on whether there are changes to the amounts known or reasonably estimated of the costs incurred during the previous financial year, except for new products. In particular, an issuer will need to consider around the end of each financial year – for example, around the end of Year 1:

(i) whether it holds new information about the indirect costs[2] for Year 0; and

(ii) to what extent the indirect cost estimates for Year 1 were impacted by new information.

(f) If after the end of Year 1 a PDS becomes out of date because of costs which have changed for Year 1, the product issuer may consider whether to rely on Class Order [CO 03/237] e.g. by posting the update on a website.[3] A number of conditions must

[1] Practically, the issuer should turn their mind to this question before the end of the year to ensure that the PDS is kept up to date and not misleading. In commencing this consideration prior to year end the issuer may need to make reasonable estimates of costs for the remaining part of the year.

[2] More generally and in addition to the consideration of indirect costs, to the extent that any part of management costs for a managed investment product or fees for superannuation has been estimated it can be relevant to undertake this assessment for such other fees and costs. While such a review is desirable, it not necessarily likely that the end of year 1 is going to coincide with any information relevant to Year 0.

[3] Up until end of Year 1, the figures in the PDS should be for Year 0. By the end of Year 1, an estimate should be formed for Year 1, of any elements of the fee and cost disclosure, that are not by then known. Realistically for determining whether a PDS update is needed, an estimate of any amounts not known will need to be produced some time before the end of Year 1 so, if necessary,

be met before the relief in the Class Order is available, including that the updated information includes no materially adverse information.

(g) In this context, materially adverse information is defined in [CO 03/237] to mean "information of a kind the inclusion of which in, or the omission of which from, a Statement would render the Statement defective within the meaning of section 1021B [of the Corporations Act]."

(h) In practice, if the difference in the updated indirect cost amount is materially adverse from the perspective of the reasonable person investor, the issuer will not be able to rely on the Class Order relief to update the PDS after the end of Year 1 and will need to either reissue or supplement (depending on the type of PDS) the PDS.

During a financial year

(i) Where new indirect costs information comes to the attention of the product issuer during a financial year, the issuer should consider whether the PDS becomes out of date or becomes misleading or deceptive. The nature and materiality of the information is relevant to this consideration.[4] A product issuer is less likely to be required to reissue a PDS in the event of a non-material increase (or a material or non-material reduction) in the indirect cost calculation compared to the amount disclosed in the PDS. Any updating needed may be done in reliance on [CO 03/237] if the update is not materially adverse and the other conditions of that class order are met. On the other hand, a PDS is likely to be required to be reissued or, where permitted, supplemented if there is a material increase in the indirect cost calculation compared to the amount disclosed in the PDS.

(j) An example of where these ongoing considerations arise for issuers is the situation whereby a trustee/responsible entity has included an estimated underlying investment fee in its PDS (e.g. based on costs for Year 0) yet thereafter (e.g. during Year 1) it receives actual figures periodically from its underlying investment providers, which figures may be greater than the estimates stipulated. One of the reasons that this situation may occur is because of the different reporting periods applied by the issuer and the investment provider. For example, where an issuer's financial year is from 1 July to 30 June whereas the investment provider's is from 1 January to 31 December.

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preparations can be made to enable appropriate updating. As at the end of Year 1, the test must be applied so at that time the earlier internal estimates must be checked and if appropriate an update made by website or if appropriate in a new or supplementary PDS.

[4] If the information is about elements of the required disclosures e.g. indirect costs of the prior year (Year 0) that makes the amounts in the PDS no longer a reasonable estimate then the PDS may be out of date and may also be misleading and deceptive and the issuer will need update it. Updating may potentially be done in reliance on 03/237 if the update is not materially adverse and the other conditions of that class order are met.

(k) This situation creates the potential for frequent updating obligations for fees in PDSs and may occur despite the fact that the issuer complies with the new fee and cost disclosure regime as at the date of the PDS and has taken into account the actual underlying fee for the previous year provided by the investment provider in order to estimate an amount for the PDS.

(l) Concerns arise in this context since issuers are dependent on information provided to them by investment providers and so generally cannot control when new fee and costs information is provided to them. Significant expense, inefficiency and investor uncertainty could result if PDSs are required to be reissued frequently and at short notice in response to new information about estimated indirect costs. In order to provide certainty for both issuers and investors, and to support the facilitative benefits of [CO 03/237] and best practice disclosure by electronic means, the following guidance should be followed:

Issuers should:

(i) **include in PDSs clear warnings that the indirect costs information[5] included is based on information available and (if applicable) estimates[6] as at the date of issue of the PDS and that the issuer's website should be referred to by investors for any updates which are not materially adverse from time to time;**

(ii) **update investors in accordance with [CO 03/237] where new costs information is not materially adverse. For these purposes, increases in performance-related fees solely attributable to higher investment outperformance (see below paragraph 6.2) are unlikely to be considered materially adverse; and**

(iii) **adopt a policy and procedure for gathering fees and costs information around the end of the financial year in order to calculate and form a view around indirect costs disclosure updates for PDSs. Issuers should ensure they have processes to identify when they come into receipt of updated costs information and therefore become aware of that information. This includes adopting a formal assessment so that issuers are able to fully assess the impact of new costs information within 30 days[7] (the "review period") of the start of the annual review process,[8] including the materiality**

[5] Issuers may also (if applicable) choose to provide this warning for any other fee and cost disclosure information that is estimated.

[6] Estimates must be reasonable. Despite including this warning, a PDS will still need to be updated if the new information makes the cost information in PDS no longer a reasonable estimate.

[7] While ASIC does not object to having a system which should ensure that a maximum reasonable period to update following new information is met, this is not a basis not to update a PDS if it has become clear an update is needed and it can be reasonably quantified.

[8] It would be more appropriate to commence collecting and considering costs information before end of financial year and, ideally, be in position to ascertain the likelihood of needing to update the PDS before end of the financial year.

of that information. If such information is not in a form or is not sufficiently complete or finalised in order to make that assessment, issuers should seek clarification before the end of the review period, noting that the extent to which such information needs to be clarified will depend on the materiality and its impact on costs disclosure. Examples of where information will not be sufficiently complete or finalised include:

(A) **where accounts are provided but in unaudited form and are subject to change as a result of the audit process;[9] and**

(B) **where the issuer is unable to reasonably ascertain the numerical impact of the information on the fees and costs disclosed in the PDS.[10]**

(iv) **If, by the end of the review period, information has been reasonably assessed in accordance with established policy and procedures and (as applicable) further enquiries reasonably made, the product issuer may then determine a reasonable basis for calculating or making an estimate of the relevant costs.**

6.2 **Performance fees**

Estimating performance fees

(a) Performance fees can be paid in a variety of situations, including:

(i) to a trustee or responsible entity;

(ii) by a trustee or responsible entity to an investment manager under a mandate;

(iii) by a trustee or responsible entity to an interposed vehicle;

(iv) to the product issuer of an interposed vehicle; or

(v) by an interposed vehicle to an investment manager under a mandate.

(b) Fees charged by interposed vehicles, or by investment managers under mandate based on returns achieved from assets they manage, form part of indirect costs[11]

[9] Confirmation could be sought if thought appropriate of unaudited information, including requesting an audit opinion. However, this is not a basis for not acting on the basis of the unaudited information within the 30 day review period.

[10] However, in general if there is uncertainty as to an amount, it needs to be reasonably estimated and it may be prudent to choose a higher estimate. There is no basis to continue to have inaccurate information in a PDS because the precise amount which is correct cannot be ascertained i.e. if there is a basis for an estimate that can be based on having taken reasonable steps.

[11] For a superannuation product such fees can be disclosed as an investment fee unless the trustee has elected for them to be treated as indirect costs.

and should be disclosed by the product issuer on the basis of the actual amount of those fees charged by such interposed vehicles or investment managers during the last financial year (except for new products). Unlike indirect costs, fees that are not costs - including performance fees for superannuation products payable to superannuation trustees, fees payable to the responsible entity of a registered scheme or any fees directly paid by members - must be shown on a prospective basis [RG97.126/7].

(c) It is acknowledged that superannuation product investment options commonly do not charge performance fees directly. However, some of these investment options invest their assets through mandates or into one or more managed investment scheme (MIS) products where performance fees do apply.[12]

(d) Unless both directly charged and indirect cost amounts are based on the same criteria, the estimates disclosed could vary between the MIS PDS and the superannuation fund's PDS. This is the case, even though both estimates ultimately relate to performance of the same assets. Given the difficulties with accurately predicting future investment performance, it follows that it is not possible to reasonably accurately estimate performance fees on an exclusively prospective basis. The use of the past financial year's actual performance fees should therefore be adopted[13] to provide consistency where performance-related fees form part of indirect costs. Accordingly, the following guidance should be followed:

Product issuers[14] should use the previous completed financial year's actual performance fees as a "proxy/default" for their performance fee estimates for the next financial year unless they have reasonable belief at the time of issuing the PDS that those past performance fees are likely to be misleading or deceptive and cause the PDS not to be up-to-date.[15]

Where the previous completed financial year's actual performance fees are considered likely to be misleading or deceptive, product issuers may instead base their estimate on average annual performance fees charged for (to the extent available) the past completed three financial years to take into account potential

[12] If the performance fee of a managed investment scheme is a cost of a super fund it will need to be disclosed retrospectively.

[13] i.e. in PDSs for managed investment products. For superannuation, performance related fees must generally be based on the previous financial year.

[14] This is relevant only to managed investment product issuers. For superannuation performance related fees must generally be based on the previous financial year.

[15] On one view, last year's fee can only be used if it is a reasonable forecast of the performance fee that will be paid prospectively. It is not sufficient to use simply because of a reasonable belief that it is not misleading. On this basis, the earlier discussion in this Guidance Note about updating PDSs when new information is known to issuers is relevant to any estimate used for a performance fee. On the other hand, the proposal to rely on the previous year is considered to reduce gaming and promotes consistency. In addition, it will reduce the need for updating during the year if it clear it is based on the previous year which may not be representative and is provided to illustrate the calculation of the disclosed formula for calculating the performance fee.

higher market volatility over a shorter period e.g. where the past financial year alone has resulted in an abnormally low or high performance fee.[16]

Where neither of the above is considered to be a reasonable basis for estimating typical ongoing performance fees, product issuers should make their estimate using whatever they consider constitutes a reasonable basis in the relevant circumstances.

Performance-related fees and itemising disclosure

(e) The definitions of "performance" and "performance fee" apply to managed investment products and superannuation products. Performance fees relate to the performance of the fund as a whole or of an investment option. The defined term does not include a fee based on returns achieved from assets managed under a particular mandate, when those do not relate to the fund as a whole or to a particular investment option. Fees based on the performance of an interposed vehicle through which a subgroup of assets of an investment option are held, or for management of a subgroup of assets of an investment option, should not be called a "performance fee" in the PDS [RG 97.123].

(f) Given that issuers are unable to use the term "performance fee" unless this is a directly charged fee, the following guidance should be followed:

Issuers should adopt the terminology "performance-related fees" where such fees are not directly charged, including to refer to costs relating to the investment performance of an interposed vehicle or a subgroup of assets of an investment option.

(g) Performance-related fees are potentially the most variable component of indirect costs from year to year. It is therefore considered open for responsible entities and trustees of superannuation funds to itemise, within any estimated indirect costs/ICR, the estimated performance-related fee amount when disclosing the fund's/investment option's total costs to facilitate easy comparison when the next year's actual costs become available. By doing so, an issuer may[17] be more likely to be able to rely on [CO 03/237] to update the relevant PDS. Without this itemisation of estimates, it may be more difficult to attribute any future increase in indirect costs/indirect cost ratio to an increase in performance-related fees for the purpose of updating the PDS under [CO 03/237], as to which see below paragraph 6.2(h).

[16] The requirement is to base the example on typical ongoing fees. Accordingly, the previous completed financial years actual performance fee will be misleading if it is not within the range of what will be typical. The same applies for any averaged figure.

[17] On one view, in terms of reliance on [CO 03/237] the question is still whether the change to the indirect cost (the cost that is required to be disclosed under Schedule 10) is materially adverse. The fact that the change to the cost is due to performance related fees, which is not mandated disclosure, does not change this requirement. On the other hand, it can be argued a client can separately assess the performance related component and the non-performance related component, so that if the performance related component materially increases an update might not be needed if the non-performance related component has not increased.

Accordingly, for those issuers seeking to disclose performance-related fees in this manner, the following guidance should be followed:

Issuers may adopt the following itemised form of disclosure for in their PDSs in the Additional explanation of fees and costs section to present estimated performance-related fees:

FUND/ INVESTMENT OPTION	MANAGEMENT FEE/ INVESTMENT FEE (% PA)	ESTIMATED INDIRECT COSTS/INDIRECT COST RATIO (% PA)		TOTAL ESTIMATED MANAGEMENT COST/ TOTAL INVESTMENT FEES & ESTIMATED INDIRECT COSTS (% PA)
		ESTIMATED PERFORMANCE-RELATED FEES	ESTIMATED OTHER INDIRECT COSTS	
Balanced	1.00%	2.50%	0.50%	4.00%

Where increases in performance related fees relative to estimated amounts may not be materially adverse

(h) As noted above, indirect costs are generally based on the previous financial year (in this example, Year 0). Accordingly, if during Year 1 the actual performance related fees are higher than Year 0 (other than those that must be disclosed prospectively e.g. new funds or fees payable to a trustee or responsible entity), that may not in itself trigger the requirement to reissue the PDS during year 1, although consideration will need to be given to whether the PDS remains up to date and whether it has become misleading or deceptive. Around the end of Year 1, the indirect costs in the PDS for year 2 will need to be calculated and will need to reflect the performance related fees in year 1.

(i) If the indirect costs in the PDS during Year 1 were based on a reasonable estimate of performance fees paid in year 0 and new information is received during year 1 in relation to that estimate, it is also necessary to consider whether the estimate remains a reasonable estimate or not.

(j) In considering the obligations on issuers to update PDSs in respect of changes in fees and indirect costs and the potential to rely on [CO 03/237] (assuming there has been an increase which is material and requires the PDS to be updated), an increase in the amount of a performance fee actually charged (including a performance-related fee incurred indirectly in an interposed vehicle) relative to an estimate in a PDS may not necessarily be materially adverse from the viewpoint of an investor.

(k) For the purpose of complying with its obligations in this context, the following guidance should be followed:

In certain situations, it may be possible for a product issuer to form the view that a material increase in indirect and/or total costs which arises from a higher actual performance or performance-related fee incurred in a current financial year relative to an estimated performance or performance-related fee disclosed in the PDS is not materially adverse from the viewpoint of an investor. For an issuer to be able to form this view (among other considerations[18]), that increase must be solely attributable to higher investment outperformance and the basis for the performance fee calculation and entitlement must have been disclosed, including a provision for ranges if for multi-manager products. In taking this approach, assuming the conditions of [CO 03/237] are satisfied, any associated updating of the PDS may then occur by website disclosure.

Examples[19]

If a performance fee is 10% of the investment performance above a certain benchmark (ie outperformance), then any amount actually charged which remains based on 10% of the outperformance is neither an increase nor a decrease to the performance fee, as illustrated below.

Performance fee		Outperformance		Fee amount
10%	x	*5% (estimated)*	=	0.5%
10%	x	*4% (actual)*	=	0.4%
10%	x	*10% (actual)*	=	1.0%

However, the following would be considered a performance fee increase, regardless of whether the actual performance fee amount charged was higher or lower than the estimate in the PDS.

Performance fee		Outperformance		Fee amount
10%	x	5% (estimated)	=	0.5%
*20%**	x	2% (actual)	=	0.4%
*20%**	x	2.5% (actual)	=	0.5%
*20%**	x	5% (actual)	=	1.0%

* Any such increase to a **(direct) performance fee** would require 30-days' prior notice to investors (ie which is an existing significant event notification requirement) and reissuing of the PDS.

6.3 "Chains" of Interposed vehicles

(a) Complex issues can arise where there is a chain of investment vehicles, whereby an issuer makes an initial investment in the first entity of the chain. In this instance, the issuer (at the "head" of a potential chain) will need to carefully consider whether the definition of interposed vehicle is met. In summary, this is a body, trust or partnership that satisfies either the assets test or the PDS test, but does not satisfy

[18] The test is whether a change to prescribed fees and costs is materially adverse – rather than a change to additional information the issuer has decided to include or to a component of the prescribed fees or costs. There could be force in the argument that whether something is materially adverse should take into account the matters stated, however this is unlikely to be unlimited. In particular, it would not justify maintaining figures that are more than 13 months old with only update under [CO 03/237] or using [CO 03/237] when the scale of the impact of the outperformance on fees goes beyond what might reasonably be expected as within the range of likelihood.

[19] These examples are provided for illustrative purposes only and are not intended for inclusion in a PDS in order to meet disclosure and content requirements.

the platform test. Further explanation of these concepts is contained in [RG 97.53-RG 97.81] inclusive.

(b) [RG 97.75] notes that in terms of identification of an interposed vehicle for the purpose of the PDS test and the platform test, the assessment can be made on the basis of the issuer's PDS, together with the assessment of the list of investments (under the platform test). By way of contrast, identification of whether an entity is an interposed vehicle under the assets test is based on what the issuer believes or has reasonable grounds to believe.

(c) Issuers should, in making decisions about identification under the PDS and platforms tests, retain copies of the relevant documents relied upon, including in the case of platforms, approved product lists, and record decisions made in this regard and retain relevant records. In relation to the assets test, the obligations focus on what an issuer believes or has reasonable grounds to believe. Issuers should refer to [RG 97.76 to 97.79] inclusive for ASIC's view on how these obligations might be satisfied by an issuer. Importantly, ASIC indicates at [RG 97.77] that there is no requirement to undertake inquiries outside the issuer to ascertain facts and determine if they would provide reasonable grounds to believe the assets test is met. However, issuers should take into account their broader legal and regulatory obligations in this regard e.g. a responsible entity's obligation to act honestly, efficiently and fairly as an AFS licensee.[20]

(d) In addition, it is noted that in cases of doubt as to whether an entity is an interposed vehicle, ASIC encourages issuers to make reasonable inquiries taking into account how material the outcome would be to disclosed fees and costs. This may include seeking information from the operator of the entity to determine whether the entity and, if applicable, any other entity in which it invests would meet the assets test. Accordingly, the following is recommended:

Issuers should take reasonable steps in such instances to determine, having regard to the fundamental objective of providing meaningful disclosure to members, whether inclusion of any relevant amounts from such "down-stream" entities would represent a material factor or influence in a reasonable member's decision to invest in or remain invested in the issuer's product. It may well be, for example, that the impact of any lower-level costs is so diluted or miniscule so as to be reasonably seen as irrelevant to any investment decision. Issuers should record

[20] Another example is a superannuation trustee's duties under the SIS Act and as an RSE licensee, including the prudential standards.

and document determinations made in this context and retain relevant records to support the taking of reasonable inquiries and steps.[21]

However, this determination on materiality of costs for such "down-stream" entities should not be taken into account when determining whether they are classified as interposed vehicles, since those entities will be classified as such by reference to the tests (platform, PDS and assets) under the Class Order.[22]

(e) The question of whether or not an issuer has or does not have reasonable grounds to believe that an entity meets the assets test can only be determined by reference to the particular factual circumstances of the issuer. In this context, as [RG 97.78] points out, the question of having reasonable grounds of belief has been considered by the High Court in George v Rockett (1990) 170 CLR 104. At 112, the Court said:

> *When a statute prescribes that there must be 'reasonable grounds' for a state of mind—including suspicion and belief—it requires the existence of facts which are sufficient to induce that state of mind in a reasonable person.*

The question for issuers then is whether, having regard to their particular factual circumstances, a reasonable person would form the view on reasonable grounds from the information available that the assets test is met.

Issuers should determine, having regard to these principles, whether "downstream" entities meet the definition of interposed vehicle. Accordingly, where an investee entity on these tests is an interposed vehicle and itself invests in a second interposed vehicle, then the costs of investing in the second vehicle must be considered in calculating the indirect costs of the "head" product or option that invests in the interposed vehicle that holds financial products of the second entity.

By way of contrast, as [RG 97.80] notes, once an entity in a chain is determined as not meeting the interposed vehicle definition, then any vehicles below this vehicle are not interposed vehicles attributable to the investment by the relevant option or product in the original interposed vehicle.

Issuers should make their determinations in this area by reference to objective and reasonable circumstances and record and retain relevant records.

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[21] However, if there are many such entities, then cumulatively they could have some impact and so it may be appropriate to add one or a small number of basis points to the disclosed costs to cover any such costs. The remoteness of the holding should not lead to a lower estimate, but it may be that it is not reasonable to take steps to quantify with the same certainty as more direct holdings.

[22] However, it is noted that if an issuer were to work out that any such costs that it has reasonable grounds to believe would exist would be miniscule, then it may not have to work out whether they are an interposed vehicle or not.

6.4 OTC derivatives

Introduction

(a) ASIC's stated purpose for including OTC derivatives costs as part of indirect costs is that these derivatives can be used to gain economic exposure to assets in a similar way to investing in interposed vehicles and so the costs involved in getting exposure should be disclosed in the same way as those involved in physical exposures.

(b) RG 97.101 provides that the costs of obtaining exposure through OTC derivatives should therefore be treated as management costs for managed investment products, or fees or costs for superannuation products.

(c) OTC derivative costs (other than for options) are to be measured as the difference between the underlying return (which may be negative) on the asset that the issuer is gaining exposure to through the derivative financial products and the actual return or loss the issuer has received over the relevant period [RG97.114]. Accordingly, calculation of the cost of this type of OTC derivative involves comparing the return of the OTC derivative to the return of the OTC derivative's underlying reference asset.

(d) For OTC derivatives which are options, the cost that needs to be included is the lesser of the premium and the difference between the acquisition price and the price to dispose of the derivative financial product immediately after its acquisition.

(e) It is also noted that ASIC does not require consideration of derivative financial products that are able to be traded on a financial market for this purpose [RG 97.102]. Many standard form derivative financial products are traded on regulated, transparent and liquid financial markets. This may include regulated financial markets such as licensed exchanges (for example, ASX Limited) and licensed swap execution facilities (for example, Bloomberg TradeBook and SEC/CFTC regulated SEF's based in the US). This is in comparison to derivative financial products that are more directly negotiated or customised, such as total return swaps over a single security or an investable index, where there is more likely to be imbedded costs that should be factored into the indirect cost of a fund.

Calculation of OTC derivative costs

(f) RG 97.103 describes the manner in which OTC derivative costs may be incurred. They include:

(i) a cost charged as an amount payable to the counterparty (for example, comprising a component of an option premium);[23]

(ii) reflected in the difference between how much the counterparty has to pay (or set off) and the value of the underlying asset or index;[24] or

(iii) by providing a price to acquire the OTC derivative that is higher than would be payable on its disposal.[25]

Issuers should take into account the following guidance on how to calculate the cost for a variety of OTC derivatives (total return swaps are not included since RG 97 already provides a number of examples: see RG 97.104 and RG 97 Appendix 2, Examples 13, 16 and 17):

Type	**Guidance**
Options	RG 97.117 provides that the cost of an option is the lesser of (i) the premium and (ii) the difference between the acquisition price (i.e. the offer price) and the price to dispose of the option (i.e., the bid price). The difference between the offer price and the bid price will almost always be lower than the premium.[26] Options include, but are not limited to, options on single stocks, indices, currencies, commodities, bonds, credit default swaps, as well as swaptions, caps and floors. Timing of recognition of cost: The cost of an option is recognised at the time the option position is opened (whether it be a long position or a short position), irrespective of when the option matures. For example, if an option is acquired during the current financial year, but matures in the following financial year, the cost is recorded in the current financial year. If the option position is closed-out prior to its maturity, no cost is recognised at the time of the close-out.

23 Another example is a component of the swap rate in an interest rate swap.

24 For example a total return swap.

25 For example the offer price on forward.

26 The exception might be for deep out-of-the money options which have a value close to zero.

Swaps	***Interest rate swaps*** The cost of an interest rate swap is the difference between the bid rate and the offer rate. Timing of recognition of cost: The cost of an interest rate swap is recognised at the time it is transacted, irrespective of when the swap matures and irrespective of whether the swap has a deferred start. For example, if an interest rate swap is entered into during the current financial year, with a two-year deferred start date and a term of five years, the cost is recorded in the current financial year. Since swap rates are usually quoted as a rate (or as basis points) per annum, the rate (or basis point) spread needs to be converted to a dollar cost. This is done by calculating the PV01[27] of the swap and multiplying it by the relevant spread. For example, if the bid-offer spread quoted by a counterparty for a 5-year Australian dollar interest rate swap with a notional of $10,000,000 is 3 basis points per annum (i.e. 0.03% pa), and the PV01 of the interest rate swap is $4,755, then the cost of the interest rate swap recognised in the financial year is which it is transacted is equal to: 3 basis points x $4,755 = $14,265 If the interest rate swap is terminated prior to its maturity, no cost is recognised at the time of termination. ***Inflation swaps*** The cost of an inflation swap is calculated in the same manner as an interest rate swap. That is, the cost of an inflation swap is equal to 100% times the bid-offer spread quoted by the inflation swap counterparty. ***Credit default swaps*** The cost of a credit default swap is calculated in the same manner as an interest rate swap. That is, the cost of a credit default swap is equal to 100% times the bid-offer spread quoted by the credit default swap counterparty. Credit default indices and credit default asset backed indices are treated in the same manner.
Forwards	The cost of a forward is equal to the difference between the bid price and the offer price. Timing of recognition of cost: The cost of a forward is recognised at the time the position is opened (whether it be a long position or a short position), irrespective of when the forward matures. For example, if a 1-month AUDUSD foreign exchange forward is entered into during the

[27] The present value of a basis point (PV01) is the change in the net present value of the swap for a one basis point move in the swap rate.

	current financial year, but matures in the following financial year, the cost is recorded in the current financial year. If the forward position is closed-out prior to its maturity, no additional cost is recognised at the time of the close-out.

Disclosure of hedging costs

(g) For a managed investment product, where the OTC derivative is acquired primarily for "hedging purposes",[28] the cost is not included as an indirect cost and therefore management cost (RG 97.109), but is instead included as a transactional and operational cost (see RG 97 Appendix 2, Example 14).

(h) For a superannuation product, where the OTC derivative exposure is acquired:

(i) directly, the cost is included in fees; and

(ii) through an interposed vehicle, the cost is included in fees unless the superannuation fund trustee has elected in writing to treat the costs as indirect costs (RG 97.101, 97.104, 97.27, Appendix 2 Example 15).

Disclosure of exposure costs

(i) For a managed investment product, where the OTC derivative is acquired other than for the primary purpose of hedging, the cost is included as a management cost except to the extent that the transactional and operational costs that would arise in holding the ultimate reference assets (or the transactional and operational costs that would arise in replicating the OTC derivative by transacting in the ultimate reference assets) is likely to exceed the cost of the OTC derivative. In that case, the cost of the OTC derivative is included as a transactional and operational cost and may be deducted from the cost that would otherwise be required to be disclosed as management costs.

(j) It is likely that the transactional and operational costs that would arise in holding the ultimate reference assets (or the transactional and operational costs that would arise in replicating the derivative by transacting in the ultimate reference assets) will be significantly higher than the actual cost of the OTC derivatives described above.[29] For this reason, for a managed investment product, irrespective of whether the OTC

[28] The Class Order should be referred to for the specific definition of where hedging will apply.

[29] This is because derivative counterparties are able to benefit from economies of scale when managing their derivatives portfolio, and this is reflected in their bid and offer prices. Derivative counterparties can hedge their entire derivatives portfolio with just a relatively few hedge transactions, and the transaction costs for these hedge transactions can be spread across the many different client derivative positions.

derivatives described in this scenario are acquired for hedging or exposure purposes, the cost will generally be disclosed as a transactional and operational cost.

(k) For a superannuation product, the disclosure requirements are the same as that outlined above. That is, where the OTC derivative exposure is acquired:

(i) directly, the cost is included in fees; and

(ii) through an interposed vehicle, the cost is included in fees unless the superannuation fund trustee has elected in writing to treat the costs as indirect costs (RG 97.101, 97.104, 97.27, Appendix 2 Example 15).

6.5 **Transactional costs**

Disclosing transactional costs

(a) Transactional costs may be incurred when investors apply into or redeem from a product or when transacting to manage a product's investment strategy. The following guidance concerns the treatment and disclosure of transactional fees, costs and expenses.

Components of transactional costs

(b) "Transactional and operational costs" are defined in cl 103 of Sch 10 (referred to in this Guidance Note as "Explicit Costs"). ASIC states that transactional and operational costs also include the difference between the price paid for acquiring an asset and the price that would be payable if it were disposed of (RG 97.52) (referred to in this Guidance Note as "Implicit Costs"). Accordingly, for both managed investment products and superannuation products, transactional costs are taken to include:

(i) **"Explicit" costs**: which include the following (cl 103 of Sch 10):

(A) brokerage;

(B) buy-sell spread[30];

(C) settlement costs (including custody costs);

(D) clearing costs; and

(E) stamp duty on an investment transaction.

[30] As defined by cl 101 of Sch. 10

(ii) **"Implicit" costs**: which includes an assessment of the difference between the price paid for acquiring an asset and the price that would be payable if it were disposed of (bid/ask price assessment). (RG 97.22 and RG 97.52)

(c) As with the assessment of other fees and costs under RG 97, product issuers are required to assess transactional costs incurred both directly and indirectly, i.e. through interposed vehicles.

(d) Costs applicable to OTC derivative financial products are to be assessed and disclosed based on the specific requirements of RG 97 and the Class Order in relation to those products. For further information, refer to paragraph 6.4 of this Guidance Note.

Classification of transactional costs: managed investment products

(e) Transactional costs, whether incurred directly or through an interposed vehicle, are not indirect costs and do not therefore form part of management costs (cl 102(2) of Sch 10). Transactional costs are, however, required to be disclosed under the “Additional explanation of fees and costs” section of the product disclosure statement. (RG 97.48, cl 209 (j) of Sch. 10)

(f) Transactional costs also include certain costs of OTC derivative financial products, provided such costs have been excluded from management costs in accordance with the requirements of RG 97 (e.g. where OTC derivatives are used for hedging purposes; see RG 97 Example 14). For further information refer to paragraph 6.4 of this Guidance Note.

Classification of transactional costs: superannuation products

(g) Superannuation fund trustees must include all the costs of investing as indirect costs, including transactional costs, as long as these costs are not a fee of the superannuation entity (RG 97.45).

(h) Apart from their inclusion in fees or indirect costs, details of transactional costs must also be separately stated under the “Additional explanation of fees and costs” section of the product disclosure statement (RG 97.46).

(i) While considered a component of a superannuation product’s transactional costs, implicit transactional costs, excluding those applicable to OTC derivative financial products, are not regarded as a component of a superannuation product’s indirect cost, as they are considered a cost of the assets of the product, not a cost relating to those assets. Implicit transactional costs, excluding those applicable to OTC derivative financial products, are therefore excluded from a superannuation product’s calculation of indirect costs (RG 97.22).

(j) Implicit transactional costs are, however, still a transactional cost and must therefore be disclosed under the “Additional explanation of fees and costs” section of the product disclosure statement. (RG 97.52)

(k) Costs of OTC derivative financial products, including those incurred through interposed managed investment products that may have been disclosed as transactional costs of the managed investment product, must be disclosed as either a fee or as indirect costs by superannuation products and cannot be disclosed as transactional costs. For further information on the treatment of costs for OTC derivative financial products refer to paragraph 6.4 of this Guidance Note.

Calculating or estimating transactional costs

(l) **General assumption**

(i) Consistent with the disclosure of other costs, the amount of transactional costs, or an estimate if the amount is not known, must be determined with consideration to the last financial year (except for new products, where reasonable estimates should be used) (cl 209(j)(ii) of Sch 10, RG 97.50).

(ii) Where the previous financial year figures are not considered to be a good indication of the typical ongoing transactional costs, issuers are encouraged to provide additional disclosure explaining the previous year figures and why ongoing transactional costs are likely to be materially different. Where reasonable, a forecast of the range of typical ongoing costs that may be expected can be provided. (RG 97.50)

(iii) Product issuers are required to disclose all transactional costs incurred by the product, including those that may be recovered (in whole or in part) through a product's applied buy-sell spread.

(m) **Product buy-sell spread**

(i) A buy-sell spread, applied to the unit price of a product on each investor transaction, reflects the estimated transactional costs incurred in the buying and selling of the product’s assets to meet investor flows. The estimated buy-sell spread is applied with consideration to the equitable treatment of all investors in the product, to ensure returns of the product are not negatively impacted as a result of the investment decisions of individual investors.

(ii) When disclosing transactional costs under the “Additional explanation of fees and costs” section of a PDS, disclosure should set out how any transactional costs resulting from client applications and redemptions will be borne. If such costs are recovered (in whole or in part) through a product’s buy-sell spread, this should be stated, along with an explanation of how this amount (being the buy-sell spread applied to each investor transaction) is determined. (cl 209(j)(iii) of Sch 10, RG 97.51)

(iii) As the buy-sell spread of a superannuation product is considered a fee, explicit transactional costs recovered as a result of the applied buy-sell spread are excluded from the superannuation product's calculation of its indirect costs. (RG 97.45, RG 97.52)

(n) **Calculation of implicit costs**

(i) Implicit costs should be calculated or estimated with consideration to the price at which an asset is acquired or disposed of and the asset's true value. Product issuers will need to determine the most appropriate data point for determining the true value of an asset. (RG 97.22 and RG 97.52)

(ii) In determining the data point at which to value an asset's true value, product issuers should have regard to a product's investment strategy and to the type of asset being valued. It may be appropriate to apply different true value data points for different investment strategies or different assets. For example, the most appropriate true value data point for a passive investment strategy may not be the most appropriate true value data point for an active investment strategy. Equally, the most appropriate true value data point for a listed asset may differ from the most appropriate true value data point for an asset traded off market.

Disclosure of transactional costs

(o) Product issuers are required to disclose all transactional costs, including those that may be recovered (in whole or in part) through a product's buy-sell spread.

(p) A portion of the total transactional costs are generally recovered though a product's buy-sell spread.

Accordingly, in disclosing transactional costs under the "Additional explanation of fees and costs" section of a PDS, in addition to those estimated transactional costs which are disclosed in connection with the buy-sell spread product issuers should determine the balance of the transactional costs by reference to the following calculation and disclose the net amount:

	Total Transactional Costs
minus	**Buy/Sell Spread Recovery**
equals	**Net Transactional Costs**

Where the buy-sell spread recovery exceeds the total transactional costs, it is recommended that the net transactional costs figure should be disclosed as nil.

(q) Set out below is a breakdown of the various transactional cost components and how they need to be disclosed in a PDS for managed investment products and superannuation products. The overview is limited to the calculation of transactional costs only and **does not** take into consideration other fees or costs which should be contemplated as part of a product's overall fee and cost disclosure.

(r) Additional guidance with regards to the treatment of transactional costs for superannuation products investing into a managed investment product is also provided.

(s) When deciding how to disclose transactional costs in a product disclosure statement, product issuers may choose to disclose transactional costs as shown under paragraph (p) above or may choose to disclose transactional costs in a more detailed manner, to include a breakdown of the transactional cost components (i.e. explicit costs, implicit costs and OTC derivative transactional costs). Where a less detailed disclosure method is chosen, given the different disclosure requirements for managed investment products and superannuation products, managed investment product issuers may choose to make available, more detailed transactional cost information, where requested by superannuation funds.

	Managed Investment Product	**Superannuation Product**	**Notes**
	Is disclosure required?		
Fees and Costs Templates			
Buy-Sell Spread	No	Yes	Per transaction fee applied to investors transacting with the superannuation product.
Indirect Costs	No[31]	Explicit costs OTC derivative "transactional costs"	Explicit costs include the explicit costs of the superannuation product (excl. those covered by the superannuation product's buy/sell spread), plus the net explicit transaction costs of any interposed entity. [32] OTC derivative costs of interposed managed investment products must be disclosed as transactional costs. [33]

[31] This refers to those indirect transaction costs, not indirect cost which are otherwise required to be incorporated as management costs in the fee template.

[32] Net explicit transactional costs of an interposed entity, i.e. those explicit transactional costs of the interposed entity not recovered by the interposed entity through the application of its own buy-sell spread.

[33] Total OTC derivative transactional costs, i.e. those OTC derivative transactional costs of the interposed entity on a pre buy/sell spread transactional cost recovery basis.

Additional Explanation of Fees and Costs[34]			
Transactional Costs[35]			
▪ Explicit costs	Yes	Yes	cl 103 of Sch 10 costs
▪ Implicit costs	Yes	Yes	Bid/ask spread assessment on all asset classes (excluding OTC derivative financial products)
▪ OTC derivative transactional costs	Yes	Yes **if** required	For managed investment products, these are any OTC derivative costs excluded from indirect costs For superannuation products, generally all OTC derivative costs are to be disclosed as either a fee or as indirect costs and should be calculated on a pre- buy-sell spread or transactional cost recovery basis.[36]
Buy-Sell Spread Recovery	Yes	Yes	
Net Transactional Costs	Yes	Yes	Sum of Total Transaction Costs minus Buy/Sell Spread Recovery
Additional Explanation of Fees and Costs			
Buy-Sell Spread	Yes	Yes	Per transaction fee to applied to investors transacting with the product. To include an explanation of how this fee is determined.

[34] cl 209(j) of Sch 10, disclosure to include a description of the fee or cost and the amount or an estimate if the amount is not known.

[35] Product issuers may choose to disclose transactional costs on an aggregated basis (i.e. including explicit, implicit and OTC derivative transactional costs) or on a per transactional cost component basis.

[36] Note:

(a) that ASIC states in RG 97.111:

It is only when derivative financial products are a means of achieving the investment strategy, rather than managing risks to achieving the strategy, that the costs in the derivative financial products would include costs equivalent to management costs of an interposed vehicle. However, in any case a derivative financial product may involve costs equivalent to transactional and operational costs and so need to be included in fees or indirect costs for superannuation products.

(b) Further,RG97.46 states that :

Apart from their inclusion in fees or indirect costs for a superannuation entity, details of transactional and operational costs must be separately stated under 'Additional explanation of fees and costs.

(c) In FAQ 19, ASIC states that:

For superannuation products, the OTC derivative financial product costs, including the transactional and operational costs (including when the derivatives are used for hedging purposes) need to be included in investment fees or the indirect costs. All transactional and operational costs will also need to be included as part of the Additional explanation of fees and costs.