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## IFSA Standards on Product Performance and Calculating Returns

*IFSA Standard 6 – Product Performance – Calculation of Returns (Standard) takes effect from 1 July 2006, more than 12 months after it was first released. The Standard should be applied by Scheme Operators when calculating and presenting returns for unlisted managed investment schemes (MIS) where scheme holder benefits are market linked.*

### Key message

*IFSA Standard 6 comes into play on 1 July 2006, and compliance with the new standard is compulsory for IFSA members.*

The Standard should be applied in the calculation of product performance, and compliance with the Standard is compulsory for IFSA members.

The main features of the Standard are:

- » specify the approach to calculating product performance
- » specify the principles to be adopted in calculating Total, Growth and Distribution Returns

- » standardise the practices, procedures and terminology relating to the calculation of Total, Growth and Distribution Returns.

The principles to be adopted in the calculation of Total, Growth and Distribution Returns in relation to a product are:

- » comparability
- » use of standard industry
- » consistency
- » being 'true-to-label'
- » use of a transparent methodology.

Paragraph 9 of the Standard provides that scheme operators must use performance price to calculate returns and that after 1 July 2006, the performance price must be the transaction price.

The Standard contains a number of formulae for the calculation of Total, Growth and Distribution Returns.



## PDS and periodic statement disclosures

Pursuant to Corporations Regulation 2001 (Regulation) 7.9.16K, new disclosure requirements apply to product disclosure statements (PDS) and periodic statements for many financial institutions. The changes fall into two categories, and are as follows:

### Key message

*New disclosure requirements apply to many financial product disclosure statements and periodic statements.*

#### For managed investment products

- » all PDS issued on or after 1 July 2006
- » all periodic statements (other than exit statements) in relation to a reporting period commencing on or after 1 July 2006
- » exit statements issued on or after 1 July 2007.

#### For superannuation products

- » all PDS issued on or after 1 July 2005
- » all periodic statements (other than exit statements) in relation to a reporting period commencing on or after 1 July 2006
- » exit statements issued on or after 1 July 2006.

The PDS must include the fee table contained in Part 2 of Schedule 10 of the Regulation. Periodic statements must contain the information in the manner specified and using the terminology used in Part 3 of Schedule 10 of the Regulation.

#### Product Disclosure Statements

Part 2 of Schedule 10 of the Regulation contains a fees and costs template (Fee Table) for products with multiple fee structures and single fee structures. The Fee Table includes the following information:

- » one amount in total for management costs. Management Costs must be calculated using the indirect cost ratio (ICR) for the fund. The ICR is the ratio of the fund's management costs that are not directly deducted from a member's or product holder's account, to the total average net assets
- » a consumer advisory warning, in the form and manner outlined in the Regulation must be located at the beginning of the Fee Table in the PDS
- » additional explanation of fees and costs must be included in the PDS. This item must include information previously not required, in the 'important additional disclosure items' in the ASIC model
- » an example of the annual fees and costs for a balanced investment option based on a balance of \$50,000 and contributions of \$5,000 is prescribed.

Part 3 of Schedule 10 of the Regulation requires a periodic statement to detail, in dollars, the amount of 'other management costs'. It must also include prescribed text explaining that this is the approximate amount of other management costs not deducted directly out of their account.

It also requires a periodic statement to include a statement of the total amount of fees, in dollars, that affected the customer's investment during the period in the form prescribed.

## Unit Pricing

ASIC and APRA released a joint guidance paper on 3 November 2005 outlining their guidelines to good practice in unit pricing (Guide). The Guide is for the life insurance, superannuation and funds management industries.

### Key message

*ASIC and APRA have released a guide to good practice in unit pricing, and while it has no regulatory value it carries an 'expectation for business in the life insurance, superannuation and funds management industries.*

ASIC and APRA have stated that the Guide is not a guide to best practice nor a mandatory set of instructions. However, APRA and ASIC expect that product providers' unit pricing practices will 'measure up' with the practices described in the Guide. Where alternative practices might be appropriate, APRA and ASIC expect that product providers will have reasonable and documented justifications for adopting alternative practices.

The Guide is split into 8 parts of which the following 6 are most relevant:

- » strategic unit pricing issues for the board and senior management
- » good practice principles for unit pricing
- » pooled investments – unit pricing and crediting rates
- » management issues
- » technical issues
- » consumer issues.

The strategic unit pricing issues for the board and senior management includes:

- » in each budget cycle, the board and senior management need to consider the resources required for unit pricing and ensure they are at an appropriate level
- » the board and senior management need to determine the appropriate level of board and senior management involvement in unit pricing issues,

including endorsement of policies and the implementation of a unit pricing policy framework

- » comply with legal obligations especially the requirement to act efficiently, honestly, diligently and impartially and in the best interests of all unit holders
- » build effective risk management cultures in the organisation. The board and senior management must demonstrate a commitment to risk management which includes supporting and encouraging staff and professional advisers to report issues, incidents and exceptions
- » risk management systems should include controls, monitoring and reporting, so that unit pricing errors are avoided or quickly identified
- » the need to take responsibility for developing and implementing a unit pricing policy framework for the organisation
- » the need to have reliable unit pricing systems, procedures and controls in place, as well as business continuity and disaster recovery plans
- » effective reports for monitoring that the board and senior management receive appropriate and timely information on unit pricing issues
- » clear delegations and accountabilities ensuring that responsibility for a function is allocated to a designated person

- » the board and senior management should manage change effectively ensuring that during periods of change, particular attention is paid to risk management
- » when responsibilities are outsourced, senior management and the board need to build and maintain effective working relationships with service providers, maintain appropriate knowledge and build and maintain appropriate monitoring systems
- » procedures must be in place so they can be promptly applied should unit pricing errors occur
- » communicate with the regulators soon after a unit pricing error is detected.

Good practice principles for unit pricing:

- » unit pricing policies and practices must be consistent with the governing documents for each product
- » sound unit pricing policies should be implemented consistently and be kept up-to-date
- » adjustments to unit price, if based on sound policy, are not unit pricing errors
- » judgment may be applied to develop estimates in some circumstances. This should only be done in circumstances where no actual values are available
- » information for unit holders should be accessible, timely and useful
- » pooled investments – unit pricing and crediting rates.

Some of the more common unit pricing issues include:

- » the use of historic pricing opens the opportunity for arbitrage
- » many pieces of information used to calculate one unit price
- » inconsistent calculation of and inappropriate allocation of transaction costs
- » the processing of applications other than on the date of receipt increases the risk of unit pricing errors
- » market disruptions
- » manual systems and work arounds are a significant cause of unit pricing errors.

The Guide contains additional guidance for products with complex structures such as fund of fund and funds that have several investment options.

## Outsourcing the Unit Pricing Function

While the unit pricing function might be outsourced, the entity remains responsible for the performance of the unit pricing function.

Outsourced functions should be monitored to ensure that agreed reports are provided and that breaches of service level agreements are reported.

When there is a change in service providers, effective communication channels need to be established.

## Technical Issues

The Guide talks about a raft of good guidance principles in relation to determining asset values.

The Guide discusses how an entity that is directly responsible for paying tax is to include tax in the calculation of unit price. This includes:

- » sound and justifiable policies need to be implemented in respect of tax treatments. The policies must be documented, explaining the methodologies, assumptions and why they are reasonable and appropriate for the fund
- » assumptions in tax pricing need to be reviewed periodically by internal and external tax specialists.

Reporting entities must use the Australian Equivalent to International Financial Reporting Standards (AEIFRS).

## Consumer Issues

The Guide discusses the disclosure of information to unit holders in respect of unit pricing, including:

- » that disclosure of this information should be in accordance with the Good Disclosure Principles contained in ASIC PS 168
- » managing errors and compensation is discussed in the Guide. The good practice principles include having policies and procedures for managing unit pricing errors.

# Further refinements to financial services regulation

*A recent Consultation Paper by the Commonwealth Treasury relating to the financial services regulatory requirements contrains 27 proposal of interest. The more significant proposals include:*

## Key message

*A recent consultation paper by the Federal Treasury contains 27 proposals for financial services regulation.*

- » Statements of advice (SOA) including:
  - information that has already been given to a client in a SOA not needing to be repeated in circumstances where further advice is provided
  - there being no requirement to prepare a SOA where personal advice is provided to a client, but no financial product is recommended to the client and no remuneration is received by the adviser
- » not needing to give a financial services guide (FSG) and SOA where a client clearly rejects the financial product or financial advice (respectively)
- » combining Chapter 6D of the Act disclosure document with a FSG similar to the manner in which product disclosure statements (PDS) are combined with FSGs
- » not being required to update a FSG where the change in the information is not materially adverse and there is disclosure on how access can be made to the updated information
- » a proposal to allow for the preparation of a standardised FSG for persons that are sub-authorised by authorised representatives

- » amend the small business test such that it includes an asset and income test for the purpose of the wholesale client test
- » allow superannuation trustees to aggregate their funds where they are the trustee of a number of funds for the purposes of the wholesale client test
- » treat 'bundled general insurance products' that are predominately wholesale as totally wholesale
- » the removal of the requirement for general insurance products to comply with the dollar disclosure obligations
- » to incorporate information into disclosure documents by reference, including information provided in other disclosure documents required by the Act
- » relief for secondary service providers from their obligations to retail clients in circumstances where the intermediary accepts responsibility for the financial services provided by both
- » changes to the scope of personal and general advice
- » an exemption from the requirement to provide a SOA in circumstances where the advice is minor or falls below an appropriate threshold
- » retail investors being able to obtain accreditation that enables them to be treated as wholesale investors with respect to dealing in financial products traded on markets
- » rationalising the Act and ASX Market Rules to reduce duplication relating to:
  - client orders
  - confirmation of trades
  - managed discretionary accounts
  - principal trading
  - staff trading
  - trading records
  - trust accounts
- » the streamlining of training requirements in ASIC Policy Statement 146
- » simplifying the rules relating to transferring investors and policy holders from outdated financial products to newer financial products and to generally rationalise outdated products
- » removing the class order relating to investor directed portfolio service (IDPS) and treating IDPS as a financial service under Chapter 7 of the Act
- » reducing the duplication of information required by both APRA and ASIC by establishing an information exchange between the 2 regulators
- » harmonising the breach reporting requirements under the Act and the Superannuation Industry (Supervision) Act 1993. Specifically, comments on the circumstances when a report needs to be provided and the relevant time frames in which to provide such information
- » amending the rules relating to PDS in-use notices such that ASIC will be better placed to determine which products are being actively marketed, and which products have been withdrawn from the market.

## IFSA Submissions

*The Investment and Financial Services Association (IFSA) recently finalised its submissions in respect of Commonwealth Treasury's consultation paper relating to financial services refinements.*

### Key message

*The IFSA submission to the Commonwealth Treasury highlights continuing industry concerns with financial services reform.*

IFSA's submissions included:

- » a product issuer should have the option of preparing either a full or short form product disclosure statement (PDS). The current provisions which allow incorporation by reference in a short form PDS from a full PDS should be amended such that incorporation by reference is permitted from any publicly available document or website
  - » establishing electronic means to convey necessary information in respect of PDSs which should include no more information than:
    - issuer's corporate name and ACN
    - name/identifier of relevant offer document
    - issue date
  - » refine the scope of the personal advice definition such that personal advice should:
    - depend on representations made by advisers rather than what the adviser considered
    - apply only where the adviser represents that a transaction is appropriate for the particular client
    - apply only if the representations were intended to be understood in that way, or if a reasonable person would have understood them in that way
  - allow appropriate warnings to identify or clarify the status of the advice
  - be directed only to decisions about transactions.
- Refinements to the definition of general advice may also be appropriate.
- The definitions of general and personal advice should be fine tuned, including providing specific exemptions in particular cases where it is not possible to provide a consistent test across all situations and consequences.
- » a financial services guide (FSG) should not be required for general advice when not immediately accompanied by other financial services such as dealing services or personal advice. This is particularly so where the general advice is provided by a product issuer about their own product
  - » support the proposal to allow a FSG to be combined with a prospectus. IFSA also suggests that FSGs of third parties (eg distributors) be permitted to be included in PDSs provided product issuers consent and the PDS is distributed by third parties
  - » 'eligible advice documents' should be allowed to be incorporated by reference in a statement of advice (SOA). Eligible advice documents might include:
    - previous SOA and pre FSG plans
    - records of advice

- relevant personal circumstances (part of client fact find)
- risk profile questionnaires
- FSG, SOAs and research reports
- IFSA suggests a 21-day standard reporting time frame be adopted
- standardised penalties/liability provisions for ASIC and APRA

IFSA submits that the following conditions ought to be placed on any document incorporated by reference in a SOA:

- each document incorporated by reference should be clearly identified with a short description and a further statement about how they may be obtained
- the SOA make mention that documents incorporated by reference will be made available to the client upon request
- the provider keep accurate records of what documents have been incorporated at any given time, and also ensure the correct version is kept
- » In respect of breach reporting, IFSA suggests the following:
  - IFSA considers the s912D reporting requirement (significant breaches having regard to a number of factors) is the appropriate threshold for both ASIC and APRA breach reporting. Any obligation to report 'likely', trivial or insignificant breaches at a particular point should be removed from the relevant legislation
  - the test to report breaches to ASIC in s601FC should be replaced with the test contained in s912D
- » the current small business test be simplified so that the same number of employees applies whatever the business type. The test should also recognise that many businesses now employ contractors and form part of larger corporate groups. Accordingly, IFSA suggests the small business test be changed such that small business means a business that, together with other businesses operated by the owner of the business (Owner) or, if the Owner is a body corporate, by any related body corporate, has fewer than the equivalent of 20 employees and contractors
- » group risk with more than 10 members should be deemed to be wholesale business
- » in addition to supporting the proposal to allow superannuation trustees to aggregate their funds for the purposes of the wholesale client test, IFSA suggests that:
  - only self-managed super funds acquiring interests in polled superannuation trusts should be treated as retail clients
  - there is a need to clarify that the retail client test in s761G(6) of the Act does not apply to non-financial services provided to trustees of superannuation funds.

### Further information

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