Freehills

Product Rationalisation Project
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

26 February 2010
By email

Dear Sirs

Product Rationalisation Project - Submissions regarding Proposal Paper

Thank you for the opportunity to make submissions on the Proposal Paper for the Product Rationalisation Project.

Our detailed submissions are set out in the attachment to this letter. Please contact Justin O'Farrell or Michael Vrisakis if you would like to discuss any aspect of these submissions. Our contact details are below.

Yours faithfully

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Overview

We welcome the proposed changes and the policy behind them. Our comments below are mainly aimed at simplifying the process as far as possible, recognising that a major imperative of rationalisations is cost savings for providers and members.

We have offered our responses to the different questions raised. Where we have no comments, we are in broad agreement with the proposals. We would be very happy to discuss these submissions if that would be helpful.

3.2.1 Legacy product test

Do you agree with the need for a legacy product test?	Yes. However, we suggest that specific confirmation should be sought from industry sources that the proposed test will cover the products they generally wish to rationalise. This will assist in an early identification of any issues with the current definitions.

Do you consider the proposed criteria and specific tests to be appropriate and clear? If not, how could they be improved? Are there other criteria or specific tests that you consider better?	We suggest two changes to the current formulation of the proposed criteria aimed at simplifying the tests to some extent: 1 It is currently required that the product 'must also not be an interest in a managed investment scheme that was closed to new members after it had raised an amount that was disclosed in any prospectus or Product Disclosure Statement as the amount was sought to be raised'. We suggest this restriction should be removed. If a product has become unworkable in the ways set out in the specific legacy tests, we see no reason why such a product should not also be capable of rationalisation. 2 We suggest the specific test for demonstrating when a product has become uneconomic for policy holders or members should be reformulated as follows: *the total number of product holders or members at the date the application for a rationalisation occurs is 50 per cent less than the largest total number or product holders over the course of the life of the product; and* • *the product holders' or members' profitability in each of the past 2 years is materially less than its maximum level over the course of the life of the product; or* • *the product provider has incurred a net operating loss on the product to be rationalised over the past two preceding financial years; or* • *the product provider can demonstrate a reasonable expectation that the product is reasonably likely to incur, a net cash operating loss over the following two financial years.* Our suggestions seek to address the issue that: • rationalisation could occur on the basis of a loss of profitability for the policyholder or member, as well as the product provider. We have not sought to precisely quantify

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this but have inserted a 'materiality' test (which could be made more specific). Funds which have had significant outflows are often disadvantaged by loss of scale (leading to higher unit costs) and the reversal of DTA (formerly FITB) balances as these become irrecoverable;

- if possible it would be preferable for product providers to avoid losses on products where they can demonstrate the product is reasonably likely to become uneconomical. The product could then be rationalised before losses crystallise.

3.2.2 Taxation relief test

Do you consider the test to be appropriate and clear?

No. The proposal that a legacy product can only receive taxation relief if the product has been closed to new members or policyholders for 5 years creates an inconsistency between the legacy product test and the taxation relief test. The application of the proposed taxation relief test will mean that a product which has been closed to new members or policyholders for more than 2 years but less than 5 years will not receive taxation relief. Without this relief, the product is likely to fail the no disadvantage test. Accordingly, if the current formulation of the taxation relief test is adopted, this has the potential to undercut the 2-year limit in the legacy product test and effectively mean that, in many cases, rationalisation cannot occur until 5 years has passed.

In addition to the above, and for the same reasons as set out in relation to the legacy product test, we believe that the requirement that the product is not 'an interest in a managed investment scheme that was closed to new members after it had raised an amount that was disclosed in any prospectus or Product Disclosure Statement as the amount was sought to be raised' is unduly restrictive and should be removed.

If not, how do you think it could be improved?

In our view, the taxation relief test should be made consistent with the legacy product test. Effectively, this will mean that taxation relief will be available (subject to the necessary approvals) where the legacy product test and no disadvantage test have been satisfied.

3.2.3 No disadvantage test

Do you consider the proposed no disadvantage test to be appropriately framed? Does it contain all the necessary key elements? Are the terms used in the test clear and practical?

A major issue for the no disadvantage test is that product providers can be forced to replicate out-moded systems so as to comply. It is also very difficult to assess how every right in a product may or may not react in every future circumstance that may arise. These questions involve considerable time, cost and expense as the product provider and its advisers seek to address every possibility. In some cases it may not be possible to determine.

If you do not consider the current test to be appropriate, how do you think it could be improved?

Replication of terms in a replacement product (usually an existing product) carries its own issues as to how that change is made, and the systems required to support the grandfathered provisions.

To address this, we suggest that the no disadvantage test be formulated somewhat less restrictively, but with a capacity for individuals who can demonstrate a later detriment to be able to recover their loss.

Are the 'factors to consider' listed above

Specifically, we recommend three changes to the current

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appropriate, clear and complete? If not, what changes should be made, or additional factors should be included?

formulation of the no disadvantage test:

1 The definition of the term 'rights' should be amended to provide that 'rights' are 'contractual rights which would impact on financial benefits'. In our view, it is likely that the test will become unwieldy if all rights and entitlements (including those that are insubstantial to the value of the product) are included in the no disadvantage test.

2 The no disadvantage test should be taken to be established if there is 'no disadvantage arising on a comparison of the benefits of the new product as a whole compared to the benefits of the old product as a whole', rather than through a case-by-case determination of whether there may be *any* possible detriment to the policyholder. From a practical viewpoint, the process of demonstrating that a change to a 'right' is highly unlikely to be detrimental to any policyholder in any given future circumstance is particularly difficult, costly and time-consuming. We believe that this may result in various kinds of non-investment products being incapable of effective rationalisation. For this reason, we suggest the above comparison as a whole with the potential for compensation on a case-by-case basis (as set out below) where needed.

3 Individual policyholders should be entitled to apply for compensation where they can demonstrate that they have suffered a monetary detriment as a result of the rationalisation. This would help ensure that individual policyholders are not disadvantaged as a result of the changes proposed above. This could be subject to a contrary court order to allow the Court to bring finality where it considers this appropriate. A time limit could also be considered (eg 6 years, being the period often stipulated for limitations of actions).

Taken together, we believe that these changes will provide a more effective product rationalisation mechanism, without the need for grandfathering, but whilst giving a member who can demonstrate a financial detriment the capacity to recover that detriment.

3.3 Managed Investment Schemes

Do you consider the proposed mechanism for managed investment schemes to be appropriate? In particular, do you think it provides an appropriate level of protection to members, without imposing an excessive burden on responsible entities?

If not, how could the mechanism be improved?

Whilst generally considering the product mechanism for managed investment schemes to be appropriate, we believe that the following changes would assist in streamlining the proposed process:

1 We suggest that members should need to be provided only with the conclusions (or a summary) of the independent expert's report, with the entire report being made available free of charge on request or on a website. The inclusion of the entire independent expert's report in the rationalisation proposal provided to all members is likely to cost excessively.

2 In relation to Option A, we recommend that:

- The '5 per cent level' be increased to 10 per cent. This is to reduce the prospect of greenmailing.
- The first sentence of paragraph 3 be amended to read

  Where the number of returned objections meets the 10 per cent level, the RE may opt to withdraw the proposal, go to a meeting or apply to the Court for approval.

This is to allow for a meeting where objectors emerge.

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3 In relation to Option B, we recommend that:

- 'Class' be defined as 'a separate class specified as such in the relevant constitution'. This will help avoid the necessity for lengthy legal advices as to what categories may or may not form a 'class' of product holder.
- The requirement for a quorum of 'at least 10 per cent by value in each class' be removed. Where a legacy product is closed and non-performing, members may decide it is not worthwhile to attend a meeting. It is likely in any event that persons supporting the change will see no need to attend. It is more likely that objectors will attend. Accordingly we do not see the need for a quorum requirement.

4 In relation to Option C, and consistent with our proposed reformulation of the no disadvantage test, we believe that the capacity for compensation should remain open, but with the Court having the capacity to decide otherwise.

5 For completeness we note that section 601NC of the Corporations Act allows the Court the power to wind up a managed investment scheme where the purpose of the scheme has been accomplished or cannot be accomplished. The process in that section would also be of relevance in this context.

3.4 Life insurance products

Do you consider the proposed mechanism for life insurance products to be appropriate? In particular, does it provide a sufficient level of protection for policyholders, without imposing an excessive burden on product providers?

If not, how could the proposed mechanism be improved?

We suggest changes to the proposed mechanism for life insurance products, as follows:

1 For the same reason as discussed above, only the conclusions (or a summary) of the independent expert's report should be provided to policyholders, with the entire report being made available free of charge on request or on a website.

2 In addition to the APRA application mechanism, product providers should have the same options as apply to managed investment schemes (ie member objections, ordinary resolution and court application). Given that the majority of life insurance products are similar to managed investment scheme products, we believe that both rationalisation processes should be more closely aligned.

3 We suggest the APRA application mechanism could be reformulated to provide that APRA must approve the rationalisation of life insurance products if the simple criteria are met. The proposal might also be considered approved (as with the Foreign Investments Review Board process) if APRA does not object to the proposed rationalisation within 40 days. We believe a concern for APRA has been the prospect of expensive challenges if it were to approve applications. This has meant a preference for the Court to approve the final terms of any rationalisation, resulting in greater expenses. We believe some appropriate protections for APRA should be developed to address this, for example where APRA has acted in good faith based on the information provided to it. The above suggestions (eg compensation from product providers for individuals who can demonstrate detriment, and a requirement for APRA to approve 'simple' cases) are also aimed at addressing this concern.
