11 October 2022

Economics Legislation Committee
Senate Standing Committee on Economics

By email to economics.sen@aph.gov.au

Dear Senators

Thank you for the opportunity to provide a submission to the Economics Legislation Committee on:

Schedule 5 of *Treasury Laws Amendment (2022 Measures No. 3) Bill 2022*.

Preliminary

By way of introduction, I am an Associate Professor at UNSW Sydney in the Faculty of Law and Justice. I research in the areas of trust law, superannuation, managed investments and the regulation of financial markets. I am also retained on a part-time basis as an External Consultant by Herbert Smith Freehills.

Prior to entering academia in 2010, I worked for ipac (1986-1994) and Frank Russell Company (now Russell Investment Group) (1994-2009, including five years as Director of Research and four as Director of Product Development). Much of that time was spent actively involved in advising superannuation funds and their stakeholders on governance matters and in investment manager research and selection.

The views expressed in this submission are informed by my experience and research, but they are my own and ought not be taken to reflect the views of UNSW Sydney or Herbert Smith Freehills, nor any of their clients, employees or associates. I make this submission in my personal capacity and not on anyone's behalf or at anyone's instruction.

Submission

I wish to comment on Schedule 5 of the *Treasury Laws Amendment (2022 Measures No. 3) Bill 2022,* (the *'Bill'*). I have in the past expressed reservations about the technical design and policy objectives underlying the annual performance test in Part 6A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (the '*SIS Act*'). I continue to hold those reservations. However, I do not propose to re-prosecute those arguments here but will focus rather on the reforms proposed in the *Bill* currently under consideration by the Committee.

I have two main reservations about the efficacy and desirability of the regime created by the provisions in Schedule 5 of the *Bill*, and one suggestion about how these could be addressed in a principled way that is consistent with the overall design of the superannuation system.

1. **IT IS IMPOSSIBLE TO ESCAPE THE NEED TO DEFINE 'FAITH-BASED' BECAUSE THAT IS THE DISCRIMINANT ON WHICH THE REGIME RELIES.** On its face, despite the fact that the regime outlined in Schedule 5 is only available to 'faith-based' products, it does not appear to require a definition of what constitutes a 'faith'. This is convenient because defining a test that would have universal agreement would be extremely difficult and politically fraught. Unfortunately, **I submit that the approach currently taken in the *Bill* does not sidestep the need to provide a definition of the term 'faith-based'**.

   The regime as outlined in the *Bill* relies on a technical sleight-of-hand. The Explanatory Memorandum ('EM') describes the regime as essentially mechanical (the EM uses the term 'automatic'), merely requiring APRA to make an assessment of whether the requisite information has been provided. As such it would appropriately not be a 'reviewable decision' under section 344 of the *SIS Act.* This status would deny a review of the merits of APRA's decision to an RSE licensee whose application was rejected.

   With respect, I don't believe this approach will be effective in immunising a determination by APRA from judicial review. The most obvious reason is that the review mechanism provided by section 344 of the *SIS Act* is not the only way in which one of APRA's decisions can be challenged. There are a range of avenues open to parties to challenge one of APRA's decisions, irrespective of whether a decision is designated as 'reviewable' or not by the *SIS Act*. I believe it is very likely that an RSE licensee faced with the existential consequences of failing the standard annual performance test would test one or more of those avenues.

   A more subtle challenge may derive from the fact that the assessment to be made by APRA cannot escape consideration of whether the proposed approach is in fact 'faith-based'. A concrete (though hypothetical) illustration may make this point clearer. Proposed section 60L lists the information that an RSE licensee seeking a determination must provide for the application to be valid. Suppose that an RSE licensee provides to APRA documentary evidence of all that is required by section 60L, including a description of the belief system that guides its investment approach. Section 60L provides that APRA 'may' then determine in favour of the RSE licensee. At this point there are two problems. The first is that the proposition in the EM that the test is mechanical (or 'automatic') is negatived by the words of the *Bill* itself – if APRA 'may' grant the application, then APRA has a discretion to exercise. The second problem is that even if the Bill were re-drafted to remove this discretionary language, APRA would still have to make an assessment of whether the approach described in the application was 'faith-based' lest the Supplementary Test be open to any applicant able to demonstrate that a bespoke benchmark was appropriate to assess the performance of the product. And herein lies the problem. Even if we assume that section 60L is not designated as a reviewable decision, the process by which APRA reaches a determination will still be reviewable. To defend a decision rejecting an otherwise compliant application in court, APRA would, amongst other things, have to be able to demonstrate the existence of a process by which the determination that the approach was not 'faith-based' was made, as well as conformity with that process. That is to say, the fact that the RSE licensee whose application was rejected would still be entitled to a review of the decision process, as a

matter of administrative law, means that APRA will need a decision process. It therefore seems to me that a cornerstone of APRA's process will have to be the discriminant on which the regime depends: whether the approach described is faith-based or not. In practice, then, APRA will require a definition of 'faith-based' in order to give effect to the regime.

Ultimately someone has to decide which approaches are 'faith-based' and can therefore potentially enjoy the benefits of the Supplemental Test provided for in the *Bill*. If Parliament does not provide a definition of 'faith-based', the definition applied will not enjoy the protection afforded by legislation. If the definition is left to APRA, contrary to the proposition advanced in the Explanatory Memorandum, decisions made by APRA under the regime will be vulnerable to judicial review of the process by which the decision was taken.

2. **THE REGIME FAILS TO PROTECT MINORITY FAITHS.** There is another problem with the approach currently anticipated in the supplementary test. As noted, proposed section 60L requires that the trustee seeking to be granted a determination from APRA that the product is a faith based product nominate specific indices to be used in the test calculation. I have argued in my submission to Treasury in relation to the *Regulations* that accompany this *Bill* that the regulatory regime should ensure formally that the indices used in such circumstances meet certain quality controls (including independence, transparency and viability). Failing to specify those quality controls is to expose the regime to the risk that the benchmarks on which the calculations rely so heavily are able to be manipulated. To date that risk has been avoided because the indices chosen are calculated and reported by reputable organisations serving a wide range of customers (many of whom perform shadow calculations of the reported indices, providing a further safeguard). Although it is possible to commission the calculation and publication of such bespoke calculations (for instance to incorporate index construction processes and rules that embody faith-based preferences), only major religions are likely to have the financial resources to commission such indices. Consistent with this, to the best of my knowledge, only Islamic (from FTSE) and Catholic indices (from S&P) are currently available from recognised index providers. The 'faith-based' regime is thus, in effect, discriminatory against minority faiths, precisely the concern that the High Court has expressed in seminal cases such as *Church of New Faith v Comm. of Pay-roll Tax* [1983] HCA 40. Acting Chief Justice Mason and Justice Brennan said [at para 80] in that case in relation to the analogous definition of 'religion' on which certain taxation statures relied:

> A definition [of religion] cannot be adopted merely because it would satisfy the majority of the community or because it corresponds with a concept currently accepted by that majority. The development of the law towards complete religious liberty and religious equality … would be subverted and the guarantees in s. 116 of the Constitution would lose their character as a bastion of freedom if religion were so defined as to exclude from its ambit minority religions out of the main streams of religious thought. Though religious freedom and religious equality are beneficial to all true religions, minority religions - not well established and accepted - stand in need of especial protection.

I submit that the criteria for entitlement to a Supplementary Test are discriminatory in the way identified as problematic by the High Court, because as a practical matter minority faiths are unlikely to be able to satisfy the requirements of proposed section 60L of the SIS Act, depriving them of the opportunity afforded more affluent, mainstream religions to use the Supplementary Test.

3. **THE OVERARCHING POLICY OBJECTIVE CAN BE ACHIEVED IN ANOTHER WAY**. Notwithstanding the reservations I have about the annual performance test as whole, I note that one of its virtues is its clarity of purpose. It is specifically designed to focus on the net return to members historically achieved by the superannuation products to which it applies, to the exclusion of all other factors. It does not purport to assess the desirability of the fund across other non-performance dimensions, nor does it purport to assess the suitability of any product that passes the test for any particular member. It is founded on a consumer protection objective that deems certain historical outcomes to be *ipso facto* harmful.

   That consumer protection objective is only one objective at play in the superannuation system. Economic efficiency and accountability are also often expressed as objectives. Less frequently expressed, but equally important are the values of personal autonomy, inclusivity and equity. Each of these objectives and values finds expression in and is embedded to some extent in the regulatory scheme that shapes the superannuation system. **I submit that the proposed exceptional treatment of faith-based superannuation products creates a new form of tension between these objectives and values that no technical analysis of the provisions can address** – ultimately the balance between these objectives is a policy decision requiring political resolution.

   That said, **I submit that the choice architecture on which the superannuation system is founded provides a principled way of resolving the tension**. Since 2012 the superannuation system has been structured to ensure that individual participants in the superannuation system can elect to exercise different levels of autonomy, from fully defaulting within a MySuper product to exercising full control in an SMSF. Choice is not imposed, but it is made available and supported. Further, **I submit that the bar for regulatory intervention for the purpose of consumer protection ought to be higher for MySuper products than for products where the individual has exercised an informed choice**. Where an individual has chosen a superannuation fund or a product based on their fully-informed and independent assessment of their circumstances, needs, objectives and preferences, we ought to be hesitant to intervene in a paternalistic manner. We ought to ensure that the individual is in fact in a position to make a fully-informed and independent decision, for instance by requiring timely and comprehensible disclosure of the information that the individual might reasonably require to make such a decision. We ought also to ensure that the individual is aware that there are default arrangements in place and that therefore no decision is required of them. We ought also to ensure that the individual is aware of the potential consequences of whatever decisions they take. However, once those safeguards are in place I believe we ought to respect an individual's right to incorporate personal factors into their decision if they choose to do so.

That suggests that **the performance test ought to apply differently to MySuper and Choice products.** The differentiation could apply at three different points: to the test applied, to the standard required and to the consequences of failure. More specifically:

i. The net performance of a Choice product ought to be measured against its publicly-disclosed benchmark, and not against the RAFE used in respect of MySuper products, because the investment strategy to which the benchmark responds is likely to be an important factor in the decision process of the members who chose the product;
ii. The performance shortfall before a Choice product has failed ought to be greater than is currently the case for MySuper products, in order that trustees of Choice products can take active investment decisions in pursuit of their bespoke objectives with less concern about falling foul of a bout of short-term underperformance ; and
iii. The more serious consequences applying to a second year of failure by a MySuper product ought not to apply to a Choice product, given failure in any year will require disclosure of that failure to all current and prospective members and those current and prospective members are, by definition, engaged and informed of both the failure and the reasons for that failure.

Arranging the annual performance test on this basis will alleviate the need to create a faith-based supplement to the annual performance test. It will permit individuals to choose a superannuation product that embodies the beliefs that they hold dear. It will also permit individuals to express other personal preferences beyond those associated with religious faith, such as environmental or ethical concerns. It is my expectation that products that respond to such deeply-held preferences can operate very effectively in the Choice environment because those preferences are by definition sufficiently salient to motivate the individual to make an active choice. Moreover, this approach also does not absolutely preclude RSE licensees following faith-based approaches from offering MySuper products. It is thus less vulnerable to a charge that it impinges on the ability of individuals to ensure that their religious beliefs are not compromised by the way in which their superannuation arrangements are administered.

Finally, imposing the annual performance test on the basis of the system's choice architecture will also alleviate the emerging practical challenges in determining whether the annual performance test applies to a range of platform-based and other innovative fund structures that may or may not satisfy the legislative definition of a 'trustee-directed product'. This is of practical important because I expect that market forces will encourage regulatory arbitrage such that those challenges will multiply over coming years. Such structures inevitably exist in the Choice sector of the system and can be accommodated without difficulty by the adjusted regime described above.

Please do not hesitate to contact me if you have any questions or require any further information or elaboration.

Yours sincerely

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