UniSuper

Wednesday, 16 May 2012

Manager
Superannuation Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir or Madam,

Submission to Treasury on third tranche of MySuper legislation

On behalf of the Board and Management of UniSuper, we welcome the opportunity to comment on Exposure draft – Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012 (i.e. the third tranche of MySuper legislation).

Background on UniSuper

UniSuper is the superannuation fund for employees in Australia's higher education and research sector. The Fund in its present form came into being with the merger of the Tertiary Education Superannuation Scheme and the Superannuation Scheme of Australian Universities in September 2000.

UniSuper offers both defined benefit and accumulation plans to its members. The Defined Benefit Division, which remains open to all new permanent employees in the sector and is portable across all participating employers, requires a fixed 14% employer contribution and standard after tax 7% member contribution. On joining UniSuper, eligible members are automatically enrolled into the defined benefit division and have a period of twelve months to decide if they want to move to an accumulation plan in which they receive the same level of contributions and insurance benefits.

Other UniSuper members, typically casual employees and those employed by 'related bodies' that are not universities, generally receive accumulation contributions at the Super Guarantee rate, with the capacity to supplement their savings through voluntary contributions, salary sacrifice and, where applicable, access to the Government's co-contribution scheme.

At 31 March 2012 there were 456,926 members accounts of UniSuper of which 217,481 were active member accounts, including 76,660 who were members of the Defined Benefit Division.

There were 239,445 inactive member accounts; i.e. accounts with UniSuper that are not presently receiving employer contributions.

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Trustee: UniSuper Limited
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UniSuper is one of Australia's largest superannuation funds by assets, with approximately $28.4 billion of funds under management at 31 December 2012.

UniSuper's comments on the Exposure Draft and the Explanatory Memorandum

Chapter 1: Fees, costs & intrafund advice

Performance-based fees

The exposure draft proposes rules that set parameters for performance-based fee arrangements in MySuper. UniSuper, as a profits-for-members fund, agrees that the charging of fees is a crucial determinant of the returns that members receive; however, we have concerns about some aspects of the proposals.

Firstly, we submit that large superannuation funds, like UniSuper, already have sophisticated performance fee arrangements which are designed to protect the interests of the fund's members, but which may not necessarily address each of the proposed criteria in the exposure draft. Even though the proposed legislation includes a carve-out for cases where the relevant performance arrangements are nevertheless in the interests of members, this creates an uncomfortable compliance risk for trustees, because they would *prima facie* be in breach of the legislation and would have to rely on the hope that APRA shares their assessment that the non-complying performance fee arrangements are nevertheless in the interests of members.

By way of example, while performance-based fees would usually be calculated on the basis of after-fee performance, there may be instances where performance fees are notionally calculated with regard to performance before-fees, but where this has been reflected in the required hurdle rate of return which must be achieved by the manager. In other words, a superannuation fund is indifferent between calculating performance with regard to performance after-fees and performance before-fees, provided that (in the case of the latter) the hurdle that must be achieved is increased by an amount corresponding to the base fees. That said, it may be difficult for a trustee to produce evidence that this was the thinking which underpinned the choice of hurdle return, which may have been stipulated many years ago, possibly on the basis of verbal negotiations with the manager and without there being any documentation to evidence the rationale.

Further, to the extent that legislation would require performance fees to be calculated with regard to investment returns after-fees, we presume this means investment returns after-*base* fees (because the payment of performance fees would result in returns after-*all*-fees being lower than the returns after-*base*-fees). This would ideally be clarified in the legislation. We also note that the exposure draft includes proposals that would only affect the calculation of performance fees paid to investment managers appointed to manage a discrete portfolio, but would not apply to performance fees that might be paid out of pooled funds in which superannuation funds have invested (e.g. managed investment schemes and private equity funds).

UniSuper is concerned that the proposed commencement date of 1 January 2013 should be postponed or include a more flexible transition process. This is because performance fees are often calculated on the basis of performance over the financial year (ending 30 June) and, if the legislation takes effect on 1 January 2013, this will require performance fees to be changed part way through the performance year. If changes have to be made, this may have to be accommodated by splitting the financial year into two halves and paying a separate performance fee for the six months leading up to 1 January 2013; but this could be contrary to the interests of members because it is usually preferable to remunerate managers for performance over longer (not shorter) periods.

UniSuper submits that given that the legislation is still in draft form and subject to change, most superannuation funds will wait until after the legislation is passed before engaging with managers to renegotiate their fee arrangements. This further shortens the amount of time for trustees to renegotiate their existing agreements prior to the legislation taking effect.
In light of the above, we would suggest that the new requirements should only take effect for the purposes of an existing performance fee arrangement, from the first performance period starting after 30 June 2013.

In any event, we note that it may be difficult to persuade offshore fund managers (who may not have any Australian presence nor many superannuation fund clients) to vary their fee arrangements, where they are opposed to doing so.

The proposed legislation would require performance fees to be calculated with regard to the performance of other investments of a similar kind. While this may generally be the approach taken, there are circumstances in which it is more appropriate to have regard to the performance of different kinds of investments – for example, the investments which you *would* have acquired if you had made a different investment decision. For example, if cash flows are redeployed from Australian equities to a more exotic asset class or sector, it may be more appropriate to compare actual portfolio performance to the returns of the broader Australian market (which is a proxy for the returns which would have been achieved in funds had not been redeployed), rather than comparing actual portfolio performance to the returns of the relevant asset class or sector.

Chapter 2: Insurance

The exposure draft and other legislative provisions released to date indicate that a substantial amount of detail around insurance will be included in regulations. As a result, it is currently very difficult for trustees to understand and assess the full suite of rules that will apply to insurance, which is a critical aspect of their MySuper and choice products. UniSuper asks that a draft of the proposed insurance regulations be released as soon as possible.

Paragraph 2.20 of the Explanatory Memorandum to the Exposure Draft leaves trustees unclear as to the extent of the differential insurance cover that will be permissible. This is exacerbated by the fact that the draft regulations on insurance have not yet been released. In particular, it is unclear whether the differential insurance can be offered only at the workplace level, or purely at the individual member level, *irrespective* of workplace/employer issues. The drafting of paragraph 2.20 should be revised to clarify the scope of a trustee's discretion to offer differing insurance levels.

Chapter 3: Collection and disclosure of information

Product dashboard

The product dashboard rules in proposed section 1017BA of the Corporations Act will apply to each choice product offered by a fund; however, the prescribed information required to be disclosed is "for each investment option offered within the choice product" (proposed section 1017BA(3)). This distinction between a choice product and an investment option is potentially confusing. There is little additional information in the explanatory memorandum. We request that this distinction be clearly spelled out in the final legislation.

Portfolio holdings

UniSuper is in favour of providing members with more detailed information about how the fund's assets have been invested. In the last 12 months, UniSuper has overhauled the investment-related sections on its website to provide additional information about the listed securities in which the fund has invested and the performance of each option, as well as the investment managers who have been appointed to manage fund assets and UniSuper's process and philosophy for selecting managers and investments. However, the proposed

legislation gives rise to numerous challenges, even for a large superannuation fund like UniSuper.

By way of example, some of UniSuper's investment options have exposure to over 5,000 securities and we query the usefulness and logistics of publishing this amount of data on a website. The Explanatory Memorandum suggests that trustees would have to disclose the number of shares held and the price per share, and we query whether this type of information is likely to be useful to members.

Other investment options have far fewer exposures (e.g. 20 to 40) and, in the case of these options, it would be relatively easy for members and other funds to replicate UniSuper's portfolios (at least at each reporting date). This kind of disclosure therefore involves the disclosure of information which is potentially proprietary to superannuation funds and/or their investment managers, and could have ramifications under agreements with those investment managers.

UniSuper is concerned that there is a risk that members might replicate these portfolios within their personal portfolios and self-managed superannuation funds. This reveals the bigger issue of whether publishing details of underlying holdings would amount to financial product advice, on the basis that superannuation funds are implicitly endorsing investments in the various companies they themselves have invested in. Since some superannuation fund trustees (such as UniSuper Limited) are not licensed to provide financial product advice, it will be important for the government to clarify that publishing this information will either not constitute financial product advice and/or that there is an exemption from the requirement for an Australian financial services licence.

The exposure draft as it stands will pose a major difficulty in the case of investment options which are marketed as being passively managed, i.e. which closely track a named benchmark index. Benchmark licensing agreements are typically governed by US laws (and are therefore not affected by the Corporations Act) and contain strict prohibitions against disclosing information about the composition of the benchmark or which enables the benchmark composition to be reverse-engineered. As such, superannuation funds which offer these kinds of investment options are unlikely to be able to comply with the legislation without breaching the terms of their benchmark licensing agreements. An exemption should be created to provide flexibility in these cases. Analogous issues are likely to arise in the case of traditional options to the extent that they include some passively managed portfolios and/or investments in ETFs or managed funds which are passively managed (because the relevant managers and benchmark providers for those products are likely to have the same opposition to the underlying holdings being disclosed).

In light of the above considerations, UniSuper would advocate for a more focussed and accessible form of disclosure – for example, disclosing the top 20 investments of each investment option. The investments could be ranked in order of size, but if the precise allocations were left undisclosed, this would mitigate the risk of members replicating these strategies. However, if the relative size of each investment must be disclosed, disclosing the percentage allocation is likely to be more useful to members than raw data which stipulates the number of shares and price per share.

UniSuper believes it will be necessary for the government to clarify (either through the legislation or by regulations) how the following factors are to be reflected in the publication of holdings data:

- The exposure draft gives rise to an issue of "double-counting". If a fund buys units in Managed Fund ABC, which in turn buys shares in Rio Tinto, the proposed legislation would require the disclosure of both the units in Managed Fund ABC and also the shares in Rio Tinto, which would suggest that the fund holds twice as many investments as it actually does. However, to disregard the vehicles through which the underlying exposures are held would be misleading to members, because members would be

unaware that they had any exposure to the interposed vehicles – which would be significant if the vehicle were ever to collapse.
- Which currency must be used when valuing international investments – Australian dollars or native currency?
- How should valuations be adjusted (if at all) to reflect currency hedging, noting that different funds may hedge different currencies to differing degrees at different times?
- How should holdings data be adjusted for derivatives positions – whether those positions be call and put options over particular securities, or futures over broader market indexes?
- How are holdings in asset classes other than equities to be disclosed – for example, debt securities? Is it the intention that securitised debt products will be subject to the same look-through, requiring disclosure of the underlying pool of securities and collateral? This is information which is likely to be difficult to obtain and to disclose.

Chapter 4: Modern awards and enterprise agreements

Schedule 4, item 5, subsection 155A(1) of the Exposure Draft will amend the *Fair Work Act 2009* so that modern awards will in practice *only* include a fund if it offers a MySuper product or if it is an exempt public sector superannuation scheme. The aim is to exclude any fund that does not obtain MySuper authorisation; however, the Explanatory Memorandum states that the Government seeks submissions from any funds that might be adversely affected by this approach.

UniSuper is named in two modern awards: the Higher Education Industry (Academic Staff) Award 2010 and the Higher Education Industry (General Staff) Award 2010 as well being included in a swathe of enterprise agreements.

The DBD remains the default option for new permanent employees upon their commencement of employment, and there continues to be full portability of UniSuper benefits across all 37 participating universities around Australia, as well more than 400 employers within the broader higher education and research sector (e.g. various medical research institutes, subsidiary companies, and commercial spin-offs).

While UniSuper intends to apply for MySuper authorisation for our accumulation option, we submit that other funds that only offer a defined benefit option might be adversely affected by this. We also submit that is contrary to the intention of the defined benefit fund exemption:

> *The Government considers that these funds [defined benefit funds] should automatically qualify as a MySuper product in respect of defined benefit members and be able to continue to receive contributions in respect of such members that do not make a choice of fund.* [1]

We submit that defined benefit funds, whether or not they offer a MySuper product, should be treated in the same manner as exempt public sector superannuation schemes and be able to be named as default funds under modern awards regardless of whether they offer a MySuper option.

Chapter 5: Defined benefit members

Schedule 5, item 7, section 6AA and item 8, subsection 10(1A) proposes to amend the "500 or more employee" test to exclude employees who are defined benefit members. We question what public policy objective this restriction achieves. We submit that this restriction, if introduced, will only limit the ability of multi-employer hybrid defined-benefit funds from tailoring superannuation offerings to existing or new employers.

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[1] Australian Government, *'Stronger Super' – Government response to the Super System Review*, (2010) 44 http://strongersuper.treasury.gov.au/content/publications/government_response/downloads/Stronger_Super.pdf

UniSuper submits that this restriction will limit our ability to respond to the changing needs of employers in the sector, some of whom might wish for us tailor them a MySuper product for certain employees (e.g. those working for a 'related body'). A large employer is large employer, regardless of whether employees are defined benefit members, and economies of scale are achieved from size regardless of the type of fund membership employees have.

Chapter 6: Transition to MySuper

Amendments to the SIS Act will introduce the new concept of an 'accrued default amount'. We note that under proposed section 20B of the SIS Act, an amount is an 'accrued default amount' if it is invested in an investment option which "under the governing rules of the fund, would be the investment option for the underlying asset(s) if no direction were given" – i.e. the fund's default investment option. It is not uncommon for a trustee to change the fund's default investment option over time. Clarification is needed as to whether section 20B is intended to only capture amounts that are invested in the fund's current default investment option, or would also include amounts invested in previous default investment options.

Conclusion

UniSuper appreciates the opportunity to comment on the Exposure Draft and asks that you give consideration to the issues we have raised. If you require more information, we are more than happy to meet with you or you can speak to Benedict Davies who manages our policy submissions.

Yours sincerely,

Terry C. McCredden
Chief Executive Officer