Submission on the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012

AMP
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INTRODUCTION

AMP welcomes the opportunity to make a submission in relation to the *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012* (**Bill**).

AMP is one of the largest superannuation providers in Australia and has assisted Australians take control of their financial futures for over 160 years. AMP provides a range of superannuation and retirement solutions which cater to all the needs of the community.

AMP acknowledges that a robust governance framework based on the core principle that trustees act in the best interests of their beneficiaries is critical to promoting the strength and integrity of our compulsory retirement income system in Australia. Accordingly, AMP is supportive of enhancing the current framework through raising standards across the industry but not where imposing additional requirements creates confusion, unnecessary complexity and uncertainty.

SUMMARY

We welcome the changes that were made to the Exposure Draft of the Bill. However, we still have significant concerns about some key aspects of the Bill. In summary, AMP is concerned that the Bill, in its current form, is overly complex, unclear and imposes unduly onerous obligations on trustees and their directors.

In our view, there is a real risk that the Bill will not achieve the Government's stated policy objective aimed at delivering better outcomes for members and a more efficient, transparent superannuation system through a range of measures designed to enhance the requirements and responsibilities for superannuation trustees and their directors. Instead, we believe the Bill is likely to reduce efficiency, reduce transparency and increase costs which will ultimately produce worse outcomes for members. In order to achieve the Government's objective, it is critical that legislation is clear, workable, and consistent with other laws dealing with similar terms and concepts. It is also important that it achieves the right balance between governance, cost and complexity.

In addition, many of the proposed new duties are directed towards achieving outcomes as opposed to focusing on the process of decision making. This will make it difficult for trustees and their directors to comply with their new duties. It will also provide uncertainty and a degree of risk as to what steps trustees and their directors will need to take to demonstrate that their powers are exercised consistently with these new duties.

AMP considers that a key issue is the need to attract quality directors onto the trustee boards of superannuation funds. For this to occur, directors will need to have confidence that they understand what their obligations are when joining such a board and believe that they can satisfy their obligations. Contrary to the Minister's response to the Cooper recommendations that there would not be a separate "office of trustee-director", the effect of the Bill is to impose a separate category of duties applying to directors of superannuation trustees. This will significantly increase the personal liability of directors.

The combination of the separate category of duties applying to directors, class actions and litigation funders is likely to create a very litigious environment where directors are regularly sued for investment losses incurred by their fund. If the Bill is passed in its current form, there will be a real question as to whether suitable candidates will be willing to take on directorships and whether existing directors will want to continue occupying their current roles. The pool of suitably qualified superannuation trustee directors is quite small and rapidly shrinking. We are concerned that the Bill will likely narrow this pool even further.

Further, the level of uncertainty and risk created by the new statutory covenants applying to trustees and their directors will increase the professional indemnity insurance costs for these directors and this is likely to increase the operating costs of the fund which will ultimately be borne by members.

1. OBLIGATIONS IMPACTING TRUSTEES

Additional trustee obligations in relation to MySuper

Duty to promote financial interests of MySuper beneficiaries

1.1 Section 29VN, inserted by the Bill, sets out a number of additional obligations for trustees offering a MySuper product. Trustees offering a MySuper product will be required to:

(a) promote the financial interests of beneficiaries of the fund who hold the MySuper product, in particular "returns after deduction of fees, costs and taxes"; and

(b) determine, annually, whether the MySuper assets (or the MySuper assets and assets with which they are pooled) are sufficient to ensure that the financial interests of the beneficiaries who hold the MySuper product are not disadvantaged in comparison to the financial interests of the beneficiaries of other funds who hold a MySuper product within those other funds; and

(c) determine, annually, whether the number of beneficiaries of the fund who hold the MySuper product and the number of beneficiaries of the fund is sufficient to ensure that the financial interests of the beneficiaries who hold the MySuper product are not disadvantaged in comparison to the financial interests of the beneficiaries of other funds who hold a MySuper product within those other funds.

1.2 The use of the words "promote", "financial interests" and "returns" in section 29VN(a) and the emphasis on cost reduction outcomes implied by subsections (b) and (c) appear to shift the trustee's duties from a process and input based duty to an outcomes based duty.

1.3 There is a well established body of law that states that the paramount duty of a trustee is to exercise their powers in the best interests of beneficiaries. It requires them to act in a certain way, to consider all aspects of their fiduciary duty and to exercise appropriate skill and care. It is directed to input and the decision-making process, not to outcomes. On that basis, trustees should not be accountable for decisions which may have been made differently only with the full benefit of hindsight.

1.4 The risk for trustees created by the proposed drafting of section 29VN is that an alleged breach of their enhanced obligations is likely to be assessed in light of the outcomes they have achieved. There is also the risk that trustees will not take into account other relevant considerations but focus only on net returns. This is because the current drafting of this provision draws undue attention to returns to the exclusion of other relevant considerations such as the risks associated with different investment strategies and the insurance offer. If the Bill is passed in its current form, trustees may adopt short term investment strategies to achieve particular returns rather than focusing on longer term investment strategies which may produce better retirement outcomes for members.

1.5 In this regard, section 29VN(a) is inconsistent with section 29VN(d)(ii) and new sections 52(6)(a)(i) and 52(8) which do require risk to be taken into account. On that basis, it is essential that trustees be allowed under section 29VN(a) to take the relevant risks into

account and from a policy perspective that they be required to take risks into account. While the Explanatory Memorandum (EM) tries to address this concern by stating that the obligation to promote the financial interests of beneficiaries necessarily includes consideration of an appropriate level of risk, the express focus on returns in section 29VN would suggest otherwise.

1.6 There is also a risk that the current drafting of section 29VN will stifle innovative investment strategies that could lead to better investment outcomes for members in the longer term.

1.7 We are also concerned that the obligation to "promote" is a vague and ambiguous concept which may embody a particular test of accountability for performance outcomes.

Recommendation: Amend the formulation of section 29VN by referring to the concept of risk as it applies to 'returns' or by specifically referring to "risk-adjusted returns". Also, redraft the section so that it is clear that the long established principle that trustee duties are based on decision making processes is not overturned and replaced with an outcomes based test.

Comparative duty to annually determine sufficiency of fund assets and members

1.8 Under section 29VN(b), trustees offering MySuper products will be required to determine, annually, whether the MySuper beneficiaries are disadvantaged in comparison to the beneficiaries of MySuper products in other funds because their financial interests are affected due to:

(a) the MySuper assets (or the MySuper assets and assets with which they are pooled) being insufficient; or

(b) the number of MySuper beneficiaries (or the number of beneficiaries of the fund) being insufficient.

1.9 The requirement to measure "disadvantage" in sections 29VN(b) and (c) by comparing the MySuper beneficiaries in other funds would be almost impossible to comply with in practice given the number and size of funds in the marketplace and the number of MySuper beneficiaries there are likely to be in those funds. It seems to require an assessment to be made against **all** other funds with MySuper products as the way section 29VN(b) is drafted does not appear to allow the trustee to select only some funds against which to conduct the comparison.

1.10 Further, it is unclear how the comparison would be made. For instance, if a fund with 200,000 members is invested in a balanced option that has a net return of 8%pa and another fund with 300,000 members is invested in a riskier investment option that has a net return of 12%pa can the trustee draw the conclusion that the financial interests of the beneficiaries of the first fund are disadvantaged in comparison to the second fund? It is also not clear whether trustees, in measuring the financial interests of the MySuper beneficiaries, can only take into account published returns or whether a wider range of factors can be taken into account such as member services. If a wider range of factors can be taken into account then this should be made clear in the drafting of the provision rather than leaving it to APRA guidance.

1.11 We believe these duties are overly burdensome. If trustees have acted for a proper purpose, upon proper consideration of the relevant factors and with due care to ensure their MySuper

beneficiaries are not disadvantaged and it later transpires that their MySuper beneficiaries are disadvantaged because of the size of their fund, it seems an unfair outcome that they would not be protected by law.

Recommendation: Remove the scale test in sections 29VN(b) and (c). If the scale test is to be retained, amend the formulation of section 29VN(b) and (c) to the effect that the comparison of external funds is removed and regulations instead be made to prescribe a list of matters that trustees should have regard to in performing the proposed scale test.

2. Contravention of section 29VN

2.1 Section 29VN allows a person who suffers loss or damage as a result of the conduct of another person that was engaged in a contravention of section 29VN to recover their loss from a person involved in the contravention.

2.2 Given the concerns we have outlined in paragraph 1 above in relation to the formulation of section 29VN, we anticipate that this would likely lead to increased litigation and likely class actions, particularly in relation to underperforming "net returns". The cost of defending such actions is likely to be high and will ultimately be borne by members.

2.3 We are of the view that it is inappropriate to impose civil liability for breach of these new enhanced trustee duties. As they do not embody trust law duties and are uncertain in their application, the penalty for breach of these duties should be statutory based such as cancellation of the trustee's RSE licence authorisation or the imposition of fines.

Recommendation: In section 29VN**,** remove imposition of civil liability for breach and replace with statutory based penalties such as cancellation of trustee's RSE licence authorisation or the imposition of fines.

3. New covenants applying to trustees

3.1 The covenants which apply to trustees in section 52 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) have been deleted and replaced with new, more extensive and more specific covenants.

3.2 The governing rules of RSEs are now taken to include the following additional covenants:

(a) where there is a conflict of interest or duty, to give priority to the duties to and interests of the beneficiaries, to ensure that the duties to the beneficiaries are met despite the conflict, to ensure that the interests of the beneficiaries are not adversely affected by the conflict and to comply with the prudential standards in relation to conflicts; and

(b) to act fairly in dealing with classes of beneficiaries and beneficiaries within a class.

3.3 In our view, the new duty of priority will not align with the trustee's equitable duties, it is unclear as to its operation and, in certain circumstances, it will be impossible for a trustee to comply with. Where a trustee has competing duties (eg: to different beneficiaries) it will not be possible for it to give priority to both.

3.4 Further, it will be impossible to comply with where a trustee is the trustee of two funds where one of those funds is transferring into the other fund on a successor fund transfer basis. In this scenario, the trustee will owe a duty to the beneficiaries of both funds and will be unable to give priority to the beneficiaries of one fund over another without being in breach of this requirement.

3.5 In these circumstances, it is very unclear what a trustee is required to do in order to discharge the duty of priority. This uncertainty is likely to lead to difficulties, risks and costs.

3.6 The part of the new covenant on conflict also requires the directors to also comply with the Prudential Standards in relation to conflicts, in addition to the obligations mentioned above.

3.7 Further, while complying with this duty, the trustee is also required to ensure that certain outcomes are achieved and that beneficiaries are not disadvantaged. It seems that the structure of this new duty of priority is inconsistent with trust law which is directed to input and the decision-making process of trustees.

Recommendation*:* Replace the requirement to achieve certain outcomes to the requirement that the trustee must have processes in place that are designed to achieve those outcomes. Further, we recommend that a regulation be made to prescribe the specific areas that APRA must have regard to in relation to the making of prudential standards in relation to the conflict part of the covenant

Investment covenants

3.8 The new covenant requires a trustee to ensure that the investment options offered allow adequate diversification.

3.9 AMP supports the proposition that each public offer RSE should be subject to a requirement to consider diversification at the whole of entity/fund level. However, we do not believe this should extend to the investment option level (except in the case of MySuper). We believe this would limit the ability of trustees to offer large investment menus or 'wrap' type products as complying with this duty will be onerous and costly.

3.10 Further, it is also worth noting that one of the key recommendations of the Cooper Review was that the duties of trustees would be less in respect of choice members than MySuper members given that choice members are engaged with their superannuation and want to take control of how their superannuation monies are invested.

3.11 These new investment covenants appear to be inconsistent with the Cooper recommendations as they will require trustees to take more onerous investment obligations for both MySuper and choice members.

Recommendation: Remove the words "and for each investment option" in section 52(6)(a). Diversification should be required at the fund level not at the investment option level. Further, in relation to choice members, the additional obligations under sections 52(6)(b) and (c) should be removed.

Insurance covenant

3.12 Section 52(7), as inserted by the Bill, sets out new covenants relating to insurance. In principle, AMP supports the introduction of an obligation on trustees to formulate and give

effect to an insurance strategy. However, many of the requirements of this covenant are unclear and may have some unintended consequences, for example, in section 52(7)(c), it is not clear what is meant by the term “inappropriately erode the retirement income of beneficiaries”. How will a trustee know what the parameters are for determining what “inappropriate erosion is”. On the current drafting of this provision, it will be difficult for a trustee to know whether they have satisfied this obligation of not offering or acquiring insurance in these circumstances;

Recommendation: Amend the formulation of section 52(7) to clarify the objective of this provision. In particular, delete section 52(7)(c).

4. OBLIGATIONS IMPACTING DIRECTORS

Covenants for directors

4.1 In addition to their existing duty to exercise a reasonable degree of care and diligence to ensure that the trustee complies with its covenants, under the new section 52A, directors will now have to comply with the following duties of a corporate trustee:

(a) act honestly in all matters concerning the fund;
(b) exercise the same degree of care, skill and diligence as a prudent superannuation entity director would exercise;
(c) act in the best interests of the beneficiaries;
(d) comply with the new conflict duties, including the duty of priority; and
(e) not to enter into contracts that would prevent or hinder the directors or the corporate trustee from properly performing or exercising functions and powers and those of the corporate trustee.

This is a significant difference from the current covenant regime and will significantly increase the personal liability of a director of a corporate trustee.

4.2 The existing operation of existing section 52(8) and section 55 of the Superannuation Industry (Supervision) Act 1993 (“**SIS Act**”) already apply to the directors of corporate trustees in their own right. However, the statement in the table on page 12 of the EM states that "… personal duties (for example, to act in the best interests of beneficiaries) do not apply to the directors of corporate trustees in their own right" is incorrect and does not reflect the operation of the existing sections 52(8) and 55 of the SIS Act. We therefore submit that the proposed new covenants for directors of corporate trustees as set out in proposed section 52A are not necessary and, accordingly, should be removed.

4.3 We submit that the objective to enhance the obligations of directors of corporate trustees under the review into the governance, efficiency, structure and operation of Australia’s superannuation system, the Super System Review, can be met by the existing operation of section 52(8) and section 55 of the SIS Act. The provisions of the SIS Act already focus on the individual who are directors of corporate trustees.

4.4 During the initial consultation of the Cooper recommendations and Stronger Super proposals, considerable feedback was provided by the superannuation industry pointing out significant issues attaching to the “office of trustee-director”. While the Government announced that they would reject the concept of an “office of trustee-director” it seems that

the concept has effectively re-emerged in the Bill. This area is of particular concern to AMP for the following reasons:

(a) AMP's superannuation funds have over 3 million superannuation members. The proposed director covenants proposed by the Bill will impose on each director of AMP's superannuation funds direct and personal duties to each and every member of these funds. This will also mean that the likelihood for legal action to be taken directly against a director by any member or class of members of such a large number of members will likely be high;

(b) The proposed director covenants would mean that directors of superannuation trustees would have much higher obligations to comply with than any other sector of the financial services industry which are comparable in size, such as, banks. Conceptually, there should be consistency in the duties of directors of superannuation funds with the duties of directors in other investment vehicles, such as listed companies and managed investment schemes;

(c) The proposed director covenants appear to undermine the principles of corporate law that a director has a duty to act in the best interests of the company. Duties are generally owed by directors to the company itself not to beneficiaries or other persons;

(d) As stated above, the proposed director covenants are unclear and appear to adopt an outcomes based approach which is contrary to the principles of trust law and equity;

(e) As stated above, it is likely that premiums for Directors & Officers professional indemnity insurance will increase and this cost will be ultimately borne by members;

(f) As stated above, it will be very difficult to attract suitably qualified candidates who are willing to take on directorships of a corporate superannuation trustee, and

(g) All the issues stated above in relation to the covenants applying to trustees will also apply to directors.

Recommendation: Remove section 52A and maintain the current regime under section 52(8) of the SIS Act requiring a director to exercise a reasonable degree of care and diligence to ensure the corporate trustee carries out the covenants in the new section 52.

5. Removal of defence under section 55(5)

5.1 Under section 55(5) of the SIS Act, a trustee has a "safe harbour" defence against an action from a beneficiary for loss or damage suffered as a result of making an investment if the trustee establishes that the investment was made in accordance with an investment strategy formulated in accordance with section 52(2)(f). The Bill proposes to remove this defence so that it will only apply where the trustee has complied with all of the covenants applying to trustees in relation to investment (and not just the covenant in relation to formulating and giving effect to an appropriate investment strategy) relevant to the member. This may include complying with the MySuper obligations in section 29VN of the Bill.

5.2 We submit that the proposed section 55(5) has actually removed the defence in relation to the investment by the directors of a corporate trustee or by the trustee. Our submission is made on the following basis:

(a) The existing section 55(3) of the SIS Act provides that a beneficiary of the superannuation entity would have an action for loss or damage that they suffer if the director/trustee breaches one of the statutory covenants.

(b) However, the director/trustee may only rely on the defence in the proposed section 55(5) if the director/trustee has established that they have complied with all the covenants applicable to them in relation to the investment. Therefore, if the director/trustee has complied with all those covenants, then the beneficiary would not have a right to bring an action against the director/trustee for loss or damage suffered by them anyway because the existing section 55(3) of the SIS Act would not operate to give them that right. The defence therefore cannot work in its current form.

(c) The drafting in the proposed section 55(5) suggests that a director may only be entitled to rely on the defence in that section if that director has complied with all the covenants relating to the investment. If this is the intention, then it will be difficult for a director to show that he has actually complied with all the covenants. For example, if an asset manager makes an investment decision under a mandate and a director was not actually involved in the decision to make the investment, then it would be very difficult for the director to show that the director complied with all of the covenants in relation to the making of the investment.

5.3 This outcome appears to be unduly unfair for trustees. Where a trustee has acted in good faith and for a proper purpose in the belief that they have complied with the covenants but it is later found that they have not complied (for instance where they may not have been able to "promote returns" or achieve the outcomes foreshadowed by section 29VN), it would appear to be patently unfair that a trustee would not be able to rely on the existing statutory defence particularly in circumstances where the breach of a covenant is minor. There is no evidence that the existing statutory defence has been abused and has served as a fair balance.

Recommendation: Retain the current statutory defence in section 55(5) of the SIS Act.