Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

17 January 2013

Dear Committee Secretary

Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Bill 2012

Thank you for the opportunity to provide a submission on this Bill.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 members who are responsible for investing $1.8 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Please find our submission enclosed. We look forward to discussing the contents with you. I can be contacted on 02 9299 3022.

Yours sincerely

ANDREW BRAGG
SENIOR POLICY MANAGER

Financial Services Council Ltd
ABN 82 080 744 163
Level 24, 44 Market St
Sydney NSW 2000
T. +61 2 9299 3022
F. +61 2 9299 3198
E. info@fsc.org.au
W. fsc.org.au

FSC SUBMISSION – Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Bill 2012

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1. MySuper and successor fund transfers

In the *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012*, a welcome clarification was made to the legislation around successor fund transfers. This meant a member who had provided a direction to the trustee of their previous fund was deemed to have given a direction to the trustee of their later fund if they were transferred to an 'equivalent' investment option under the successor fund transfer (**SFT**) rules.

Prior to this clarification, all members who had been subject to an SFT would be deemed MySuper members, despite the fact they may have made an investment choice in their previous fund. Given the industry has been through merger and consolidation activity to build longer term scale and sustainability for the benefit of members, this could have resulted in an adverse outcome for a significant number of members (for example over 75% of the customer base of one of FSC's member funds has been successor fund transferred).

There is one remaining area where the industry will face challenges in implementing the draft legislation with respect to SFTs: the assessment of 'equivalency'.

Assessing equivalency

While the amendments are welcome, they may be onerous. This is because a trustee may need to ascertain whether ***each*** individual investment transfer was equivalent, which is above and beyond the standard legal test for SFTs.

Briefly, the *Superannuation Industry (Supervision) Act 1993* (Cth) and *Regulations* (**collectively, SIS**) require that a trustee satisfy itself before approving an SFT (assuming the SFT otherwise is in the best interests of the members concerned), that the overall bundle of rights to benefits of members is at least equivalent in the new fund, when compared with the rights to benefits members had in the previous fund. While the mapping of members' investments is a very important component of this test, this mapping does not have to be identical or even equivalent as such;, ***provided that*** the member's overall bundle of rights to benefits (fees, , investments, insurance, etc) remains equivalent.

Practically, while a trustee would usually seek to transfer the member to an equivalent investment option in the transferee fund, this may not be possible if a particular type of investment option is unavailable in that fund. For example, the member may be invested in an Asian Share Fund in their current fund. If such an option was not available in the new fund's menu, the trustee would ordinarily seek to invest the member's money in the nearest equivalent option, which might be an International Share Fund. This would still meet the standard SFT test if the member's overall bundle of rights to benefits was equivalent.

While this situation is uncommon, we believe it is necessary to provide trustees with legal certainty when this situation does arise.

RECOMMENDATION
Expand the current references to 'equivalent investment option' in the legislation to include 'replacement investment option' so that the trustee can transfer members to the 'most' 'equivalent' or 'replacement' satisfactory investment option in the new fund.

2. Dual regulated entities

It is common in the financial services industry for a body corporate to act as both an RSE licensee (of an APRA regulated superannuation fund) and also a responsible entity (RE) licensed with ASIC. APRA's consent is obtained under the RSE licence and the RSE is subject to periodic supervisory reviews to ensure compliance with their licence requirements.

Thus, the body corporate's activities:

a) as an RSE licensee are governed by the RSE licensing rules of SIS and (in many cases) the Australian financial services licensing rules in the *Corporations Act 2001* (Cth) (**Corporations Act**); and
b) as a responsible entity (**RE**) are governed by the managed investment scheme and Australian financial services (**AFS**) licensing rules in the Corporations Act.

In those situations where the trustee of a superannuation fund holds both an RSE licence and an AFS licence, section 912A of the Corporations Act exempts the trustee from the following obligations as the holder of an AFS licence:

a) the obligation to have available adequate resources (including financial, technological and human resources) to provide the financial services covered by the AFS licence and carry our supervisory arrangements; and
b) the obligation to have adequate risk management systems.

This is chiefly because APRA will already consider these matters as part of their licencing and ongoing supervisory process. Moreover, dual regulated entities generally don't separate the management of their responsibilities under their different lines of business (e.g. RE and RSE) and policies such as strategy, risk management and investment management usually cover all areas of the business. This exemption has been important in maximising these efficiencies while also minimising duplication.

However, the Bill removes the current exemption for these dual regulated entities from having to meet these Corporations Act resources and risk management requirements applicable to responsible entities. As a result of these proposed amendments:

a) the obligation to have available adequate resources would apply to the body corporate in relation to its activities both as an RSE licensee and as a responsible entity; and
b) the obligation to have adequate risk management systems would also apply in relation to activities both as an RSE licensee and as a responsible entity, except to the extent that a particular risk relates solely to its activities as an RSE licensee.

It is likely that the removal of the exemption will duplicate requirements and require a substantial increase of financial resources to be held by dual regulated entities. For example, many of our members have indicated that the removal of the exemption effectively doubles the capital reserve that must be held against their RSE and RE businesses – this may be onerous in light of APRA's new operational risk reserve requirements. We estimate the increase in capital required across the wealth management industry will be hundreds of millions of dollars.

We recognise the challenges faced by APRA and ASIC in developing the various capital proposals and achieving a level of consistency and coordination. This is made particularly difficult due to their different mandates of prudential supervision and consumer protection, and their respective responsibility for different segments of the industry.

However, it is widely accepted that APRA and ASIC have a robust and well established working relationship. As noted in ASIC's submission[1] to the PJC inquiry into the collapse of Trio Capital there are a number of ways in which ASIC and APRA collaborate, including regular information exchanges, liaison meetings and joint projects. These regularly occur formally and informally.

The basis of both the ASIC and APRA financial (capital) requirements lies in ensuring adequate resources to absorb operational risk losses. This is recognised by APRA in its prudential standard SPS 114 where operational risk is defined broadly and ASIC in its explanatory statement for the Class Order stipulating financial requirements for responsible entities (Class Order 11/1140).

Given both the RSE and RE requirements may address operational risk (albeit via different methodologies) we believe compliance with both requirements may be excessive. This is so especially as there would be implicit diversification between the risk classes and also within the same risk class, which the standards do not accommodate.

We recognise the Government's rationale for removing the existing exemption in order to address the gap in regulatory coverage that may exist for certain REs. However, there are unintended consequences which may flow from this decision without consideration of how APRA and ASIC's capital regimes operate alongside each other.

We do not believe this to be the Government's policy intent, which is seemingly to instead address situations where REs may be able to take address the potential for regulatory arbitrage.

RECOMMENDATION
The legislation should be clarified so that for dual regulated entities, the same assets can contribute towards both ASIC's and APRA's financial resource requirements. We would be pleased to work with the Committee and Parliament in drafting the necessary amendments.

3. Service providers and de-entrenchment provisions

The Bill overrides any provision in the governing rules of a superannuation fund that requires the trustee to use a specified service provider, investment entity or financial product. While we support the policy intent of the proposal, we are concerned that the scope of the changes under section 58A appear to be much wider than that, as any provision which specifies a person from whom the trustee "may or must" acquire a service or an entity or financial product in which the trustee "may or must" invest, will be void. Thus, the new provision seems to apply regardless of whether the clause is permissive or mandatory. We understand the intent to be that the prohibition should apply only where the requirement is mandated.

Additionally, the effect of the proposed legislation appears to void an ***entire provision***, rather than just being limited to the parts of a provision that offend the legislation. As such, where a provision in a clause contains various elements relating to related parties, as would be the case with a standard type of conflicts clause, the entire clause may be rendered void. Such a provision will be included in the Deed to overcome any risk involved in permitting (not compelling) the use of related parties. These types of clauses are included for prudence and clarity. However, if the clause is rendered void then this will raise considerable legal risk as to whether a related party can be used at all.

[1] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-PJC-submission-Trio-September-2011.pdf/$file/ASIC-PJC-submission-Trio-September-2011.pdf

Our understanding is that it was not intended that the provisions operate to prohibit the use of related parties; however that may be an outcome if the current drafting were to proceed. Some examples of key clauses in a Trust Deed which may offend the above provisions include:

a) *Conflict clauses* - a clause which provides that the Trustee may deal with itself, contract with any person associated with the fund and transact or deal with a related party;
b) *Authorised investments clauses* - a clause which provides that the Trustee may invest in a fund of which the Trustee or a related party is the manager, operator or trustee or invest in an insurance policy where the Trustee or a related party is the insurer;
c) *Administration/investment management/custodian clauses* - a clause which provides that the Trustee may use the services of a related party administrator/investment manager/custodian.

As noted above, at its most extreme, the way the proposed legislation has been drafted, it may operate to prohibit the use of related parties by rendering void any provision such as these which is included in the Trust Deed to permit their use. This particularly would have profound ramifications in any conglomerate group.

Depending on the way in which the clauses are drafted (i.e. if they make specific reference to the use of related parties), the legislation could also render void in their entirety an authorised investment clause and a clause allowing appointment of any administrator, investment manager or custodian (even if they are unrelated). We believe this is an unintended consequence of the legislation and the legislation should be amended to reflect the original exposure draft.

RECOMMENDATION
The legislation should be clarified to only override governing rules of a superannuation fund that stipulates the trustee <u>must use</u> a specified service provider, investment entity or financial product.

4. Direction of contributions - Trustee and employer obligations

The following relates to the interaction of section 29WA SIS with section 32C(6) of the *Superannuation Guarantee Administration Act 1993* (Cth.) (**SGAA**). The new section 29WA was introduced into SIS by the *Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012* (**MySuper Act**). We believe there is currently a mismatch between the employer's superannuation contribution obligation to satisfy choice of fund, and the trustee's obligation to make contributions to a MySuper product under section 29WA *Superannuation Industry (Supervision) Act 1993* (SIS Act), which requires correction.

In summary, there are two issues. The first relates to the extent or scope of the transitional arrangements for which contributions made by employers are exempted from the MySuper provisions. The second relates to the drafting of the relevant provisions which may cause employers and trustees to breach relevant obligations because the relevant provisions do not interrelate effectively.

Changes to Choice of Fund Legislation

The choice of fund regime contained in Part 3A of the SGAA requires employers to provide employees with a choice of fund form which specifies a default fund to which contributions must be paid by the employer , if the employee does not elect a superannuation fund. Under section 32C(2) of the SGAA, a contribution by an employer to a default fund which meets the requirements set out in that section, will be deemed to satisfy the choice of fund requirements.

The MySuper Act amends section 32C(2) SGAA, to require the default fund specified in a choice of fund form, amongst other things, to offer a MySuper product.

Section 32C(6) SGAA has been amended by Schedule 4, Part 2, item 10 of the *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012* (**Further MySuper Act**). Currently, section 32C(6) deems certain contributions to a superannuation fund which are made by an employer, to be in compliance with the choice of fund requirements:

> "*if the contribution, or a part of the contribution, is made under, or in accordance with the following transitional instruments from various industrial relations regimes:*
> *(a) a pre-reform certified agreement; or*
> *(b) an AWA*[2]*; or*
> *(c) a pre-reform AWA; or*
> *(d) a collective agreement; or*
> *(e) an old IR*[3] *agreement; or*
> *(f) an ITEA*[4]*; or*
> *(g) a workplace determination; or*
> *(h) an enterprise agreement*."

Section 12A SGAA provides that these transitional instruments have the same meanings as in the *Fair Work (Transitional Provisions and Consequential Amendments) Act 2009* (**FW Transitional Act**).

The Further MySuper Act amendment to section 32C(6) adds 2 more transitional industrial instruments to the list of instruments set out in that section. These are:

- an award mentioned in paragraph 2(2)(a) of Schedule 3 to the FW Transitional Act, as section 32C(6)(i), which is an industrial instrument made by the Australian Industrial Relations Commission under the *Workplace Relations Act 1996*; and

- a State reference transitional award or common rule, as section 32C(6)(j) (a reference to this instrument also has been added to section 12A SGAA).

The Revised Explanatory Memorandum for the Further MySuper Act on page 53 in the last row of the first column in the table, explains this amendment as follows:

> "*Contributions under two further award-based transitional instruments are deemed to be compliant with the choice of fund requirements under the SG Act. Default funds listed in these instruments will therefore not be required to offer a 'MySuper product' or otherwise comply with the new requirement.*"

A further explanation of the amendment appears at paragraph 4.38:

[2] Australian Workplace Agreement.
[3] Industrial Relations.
[4] Individual Transitional Employment Agreement.

> "*The effect of this amendment is that a contribution to a fund by an employer for the benefit of an employee is deemed to have been made in compliance with the choice of fund requirements if the contribution, or a part of the contribution, is made under or in accordance with such instruments. Such contributions will therefore not have to be made to a MySuper product.*"

These instruments have been added to section 32C(6) because of concerns the instruments will continue to operate on 1 January 2014 when the MySuper requirements commence, and therefore should have the benefit of transitional arrangements (refer paragraph 4.40, Revised Explanatory Memorandum for the Further MySuper Act).

The wording of the Revised Explanatory Memorandum therefore indicates that contributions in accordance with section 32C(6) will continue to be deemed to satisfy the choice of fund requirements, without having to fulfil the criteria in section 32C(2) for default funds. That is, the funds to which contributions are made in accordance with section 32C(6) will not have to offer MySuper products.

Section 29WA

New section 29WA SIS however, requires a trustee of a superannuation fund to make contributions into a MySuper product where the member has not given a written election to the trustee that the contribution (or part contribution) is to be paid into a specified choice product or products.

Transitional arrangements for the application of the section are contained in items 12 and 13 of the MySuper Act. Of relevance to the current issue, is that item 13 provides that section 29WA only applies to contributions made on or after 1 January 2014.

Contributions made by an employer in accordance with section 32C(6) would not be made pursuant to a written election by the member. Accordingly, an employer who makes a contribution on or after 1 January 2014 to a non- MySuper product in a superannuation fund as specified in a transitional instrument and in accordance with section 32C(6) would satisfy choice of fund requirements.

However, the superannuation fund trustee upon receipt of the contribution would be forced under section 29WA to direct the contribution to a MySuper product in the fund, in breach of the employer's direction. It is unclear whether this would also result in a breach of the industrial instrument by the employer (exposing the employer to potential prosecution and civil penalties) where the employer has correctly contributed in accordance with the terms of the industrial instrument, however an intervening act of the trustee ultimately causes the employer contributions not to be made in accordance with the obligations specified in the industrial instrument.

As discussed above, the Revised Explanatory Memorandum makes it clear that it is intended that contributions made by an employer in accordance with section 32C(6) will remain compliant with choice of fund requirements, and that such contributions will not have to be made to a MySuper product.

We therefore think there is a mismatch between the employer's superannuation contribution obligation to satisfy choice of fund, and the trustee's obligation to make contributions to a MySuper product under section 29WA, which requires correction.

<u>Exceptions to Section 29WA</u>

We note that the list of instruments in section 32C(6) SGAA includes an "enterprise agreement" made under the *Fair Work Act 2009* (Cth.) (**FW Act**).

The transitional provisions in Item 13 of Schedule 4 of the Further MySuper Act state that section 29WA SIS does not apply to contributions made in accordance with an enterprise agreement approved before 1 January 2014, but does not mention any of the other types of instruments in section 32C(6).

We recognise the importance of the 1 January 2014 date given that from that date, the new section 194(h) of the FW Act (inserted by the Further MySuper Act) will make it unlawful to include a term in an enterprise agreement which has the effect of requiring or permitting contributions for default fund employees covered by the agreement to be made to a superannuation fund that does not offer a MySuper product.

It appears odd that there are no such transitional rules for the other transitional instruments listed in section 32C(6) SGAA, including the two new ones added by the Further MySuper Act. This transitional provision for enterprise agreements, opens up a question about why it is necessary to exclude pre-1 Jan 2014 enterprise agreements but no other transitional instruments from the operation of section 29WA. This may be an oversight. Regardless, the issue demonstrates the complexity of the area and the necessity to revisit the various items of legislation as we have mentioned.

RECOMMENDATIONS

We recommend that an amendment be made to Item 13 of the Further MySuper Act as follows:

"Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012

1 Item 13 of Schedule 4

In the heading, insert "to" before "apply" and delete "enterprise agreements" and replace with "transitional industrial instruments".

2 Item 13(1) of Schedule 4

After "This item applies if", insert "(a) or (b) applies".

3 Item 13(1)(a) of Schedule 4

Renumber sub-paragraph (a) as "(i)".

Insert: "(a) all of the following apply:" as a new sub-paragraph, immediately before sub-paragraph (i).

4 Item 13(1)(b) of Schedule 4

Renumber sub-paragraph (b) as "(ii)".

Renumber sub-paragraphs (i), (ii) and (iii) as (A), (B), and (C) respectively.

5 Item 13(1)(c) of Schedule 4

Renumber sub-paragraph (c) as "(iii)".

Insert "a contribution is made by an employer pursuant to section 32C(6) of the SG Act, other than pursuant to section 32C(6)(h) of that Act." as new sub-paragraph (b), immediately after sub-paragraph (iii).

6 Item 13(3) of Schedule 4

Insert " ***SG Act*** means the *Superannuation Guarantee (Administration) Act 1992*." in the appropriate alphabetical order."

5. Direction of contributions – choice products and transition to MySuper

As outlined in previous submissions, the FSC has been concerned that the drafting of the MySuper legislation, both in relation to the treatment of existing member balances and future contributions, would create a significantly wider application than expected. That is, these provisions would not be limited to traditional "default members" enrolled by an employer in a fund. Accordingly the FSC is grateful that the Parliament supported amendments to the Further MySuper Act in December 2012 which mitigated some of the impacts on *member balances* in existing choice products.

These amendments recognised that a significant proportion of members in choice products would be inadvertently captured by the Accrued Default Amounts (ADAs) provisions. However the current drafting of Schedule 1, item 44, paragraph 29WA(1)(c) and item 46, subsection 29WA(4) effectively negates these provisions by capturing the same members for ongoing contributions.

The rationale for excluding these choice accounts from the creation of ADAs is the same for excluding them from the obligation for placing contributions into a MySuper product. Whilst the impact on retirement savings will not be as great because the balances will not be forced from the chosen product to MySuper; the member communication, disruption, systems and product development work created by redirecting their contributions is almost identical.

Further, it would appear strange and confusing to an existing member that their future contributions must be directed to MySuper whilst their accumulated superannuation balance remains in their chosen product.

When combined with the disruption and cost required to implement this change and the overall benefits of having alignment between these two interrelated pieces of legislation, our recommendation is to deem that the trustee has been given a direction for contributions to an investment option where the balances are not classed as ADAs or are otherwise excluded as ADAs under the provisions of s20B of the Further MySuper Act. . It is essential for the integrity of the system that these provisions operate in harmony.

RECOMMENDATION

Subject to the exclusions below, limit the direction of future contributions to a MySuper product where the member has given the trustee (or trustees) of the fund no direction on investment.

The following exclusions shall apply:

1. The contribution is directed to an investment options in which all assets invested under the option are held as cash; or
2. Where the member has provided an investment direction to a trustee of a previous fund; or
3. The member's account balance includes an amount which is excluded from the accrued default amount provisions under section 20B

6. Cash

The drafting under Section 20B of the Further MySuper Measures Act 2012 provides an exclusion from the “accrued default amount” provisions for cash investment options.

This definition, although clear in the Explanatory Memorandum only includes currency or cheques, we believe the law should be explicit this it includes cash management trust accounts and other cash vehicles.

Accordingly we have suggested a minor amendment to give effect to this view: amend sub-clause 30B(3)(c)(iv) to read as follows

RECOMMENATIONS

(Amendments underlined):

"(iv) an investment option under which the investment is held <u>either directly or indirectly</u> as cash; or"

At end of sub-clause 30B(3)(c) insert the following:

"For the purposes of sub-clause (iv), a direct or indirect investment held as cash may include an investment in a cash management trust, managed investment scheme, wholesale managed fund or other trust structure or cash mandate arrangement."

It would also assist if the EM made it clear that it was intended to catch cash-like options that are used as defaults and this could include options that are held by way of wholesale managed funds, managed investment schemes or other trusts.

7. Director provisions

Under the current section 55(5) directors are protected from a beneficiary of the fund for loss or damage where they have followed the direction the beneficiary provided that the investment was made in accordance with the investment strategy formulated by the directors.

The Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012 (Cth) amends section 55(5) from 1 July 2013. Under the new section 55(5):

Directors will be protected from a beneficiary of the fund for loss or damage only where the trustee has complied with the following covenants that apply to the trustees in relation to the investment made by the beneficiary:

- all of the covenants (and not just the covenant relating to the formulation of and the giving effect to an appropriate investment strategy); and
- for a MySuper beneficiary, the new obligations in relation to MySuper.

The tightening of the existing defence in section 55(5) is likely to raise a concern as directors may only rely on that defence if it has complied with all of the covenants and not (as is currently the case) demonstrating that the investment was made in accordance with the investment strategy formulated by the trustee under the covenant.

The proposed hurdle that a person who brings an action under section 55(3) of the Superannuation industry Supervision) Act 1993 requires leave of the court to do so if the action is brought against a director of a corporate trustee of a superannuation fund (proposed section 55(4A) **does not** address the shortcomings with the present formulation of the defence under section 55(5).

Accordingly, the defence may not be useful because of the requirement to comply with each covenant. A director should be entitled to use a defence which is relevant to a claim by a member and the related financial loss.

A claim by a member should be linked to the breach of a particular covenant. That is, the financial loss should be linked to the breach and not to unrelated covenants.

Where the trustee has complied with a covenant, the defence should be available. For example, where the trustee has formulated an investment strategy in accordance with investment covenants, they should be entitled to use the defence.

RECOMMENDATION

Accordingly, we recommend that the drafting of these provisions be revisited so that directors are provided with a clear defence where a director has complied with the provisions relevant to that covenant. We recommend it should be a defence if a defendant establishes compliance with the relevant covenant or other obligation which is claimed to give rise to the loss or damage claimed to be suffered.