FSC FINANCIAL SERVICES COUNCIL

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

12 March 2012

Dear Mr Fletcher

FSC SUBMISSION – SUPERANNUATION LEGISLATION AMENDMENT (TRUSTEE OBLIGATIONS AND PRUDENTIAL STANDARDS) 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 and financial advisory networks. 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 Stock 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

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INDEX

1. **INTRODUCTION**
2. **RECOMMENDATIONS**
3. **TRUSTEE OBLIGATIONS TO MYSUPER MEMBERS**
4. **COVENANTS FOR RSEs**
5. **COVENANTS FOR DIRECTORS OF RSE LICENSEES**

1. INTRODUCTION

Context

The Financial Services Council (FSC) welcomes the opportunity to provide comments on the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2011, which is the second in a number of tranches of Stronger Super related legislation.

MySuper, as announced by the Minister for Financial Services and Superannuation on 21 September 2011, has been substantially improved for consumers, employers and the superannuation industry through the course of extensive consultation.

This Bill contains a number of the elements of the MySuper policy endorsed by the government during the 2010 election and subsequently reaffirmed in December 2010 and September 2011. It also contains significant changes to the general covenants applying to trustees of superannuation entities and the directors of corporate trustees and related matters and the conferral on APRA of a prudential standard making power.

Creation of the choice architecture model

The FSC believes the adoption of the choice architecture model as recommended by the Super System Review will clearly segment the superannuation industry into “MySuper” and “Choice” regulatory spheres. MySuper and choice segments will have varying legal obligations for trustees, appropriately reflecting the level of engagement and active decision-making of members who choose their own fund and/or investment strategy.

Under this model, a choice trustee is able to offer a range of investment options to a member, but the member determines the investment selection, degree of diversification, etc. In the MySuper sphere, the trustee is required to provide a single, diversified investment strategy in order to meet their obligations.

Prudential standards for superannuation

The FSC supports a higher regulatory standard of governance in the superannuation system. Accordingly, we welcome the introduction of balanced prudential standard making powers. The rationale behind imposing prudential standards in superannuation is compelling, in terms of harmonisation with other APRA regulated industries, the compulsory nature of superannuation

and broader community expectations around governance requirements for regulated superannuation vehicles.

It is important, however, that the scope and extent of APRA's standard making powers is clearly articulated and established in the law, given that standard making powers are subordinate to government policy decisions encoded in legislation.

Regulatory Impact Statement

There is an inadequate Regulatory Impact Statement on the Bill. The only RIS is from September 2011 and contains a broad analysis titled 'Stronger Super implementation'. The governance section only includes an analysis of the office of trustee director but doesn't examine any of the specific proposals which are now proposed in the Bill before this Committee.

FSC submission

Given the truncated timeframe provided for making submissions, the FSC has sought to outline in a concise manner the substantive matters in the Bill that we feel require amendment.

In summary, the FSC's primary concerns with the Bill are two-fold:

(a) that it imposes a scale test which is unworkable, ambiguous, complex and onerous resulting in adverse consequences for both members and RSE licensees; and
(b) the creation of a separate category of duties for directors of superannuation directors could result in more conservative decision-making, as well as adversely affecting the ability to attract quality candidates for directorship and increasing the costs of professional indemnity cover which would ultimately be borne by members.

We welcome the opportunity to discuss our submission in more detail.

2. SUMMARY OF RECOMMENDATIONS

Trustee Obligations to MySuper Members

1. MySuper members should not have their interests prioritised over that of any other member of the same fund on a comparable basis. Accordingly, section 29VN(a) should be deleted and the existing SIS provisions should continue to apply.
2. The proposed scale test should be removed. Failing removal it should be amended to provide for an entity level non-comparative test that allows a trustee to also consider a finite list of other relevant factors.
3. Item 17 and proposed s56(2A) should be omitted from the Bill.

Covenants for RSEs

4. Amend section 52(6) by removing references to 'each investment option offered' to allow trustees to continue to offer members investment choice and allow the member to create their own diversified portfolio
5. The Government's proposal to apply both APRA and ASIC capital requirements to dual licenced entities is subject to consultation with stakeholders to assess the capital costs, fee and potential impacts on industry consolidation (and competition).

Covenants for Directors of RSE Licensees

6. The current regime requiring a director of a corporate trustee to exercise a reasonable degree of care and should be maintained. Further individually applicable covenants should be removed from the Bill. Failing removal, the penalty regime for the director covenants should be replaced with one mirroring the penalty regime for a breach of the director duties in the *Corporations Act 2001* (Cth).

3. TRUSTEE OBLIGATIONS TO MYSUPER MEMBERS

Maximise net returns

We believe that existing general law / statutory provisions are sufficient in ensuring that the trustee is maximising the financial returns of MySuper members. For example, it is commonly considered that the duty to act in the best interests of beneficiaries in section 52(2)(c) involves a duty to act in their best financial interests.

The FSC recognises, however, that the government seeks to provide a specific duty for trustees to maximise the financial interests of MySuper members. Accordingly, we broadly support the intent of the new trustee obligation captured under Section 29VN to maximise net returns for MySuper beneficiaries.

We believe one element of this new duty to maximise returns, however, is not appropriate. Section 29VN provides that trustees are required to 'promote' the financial interests of MySuper member interests. The use of the term 'promote' is ambiguous and not common trustee terminology. To the extent that ‘promote’ is used in the sense of priority, requiring the trustee to prioritise MySuper members over that of other members (choice members), this is inconsistent with the general trustee obligations to act in the best interests of all members and to treat all members fairly.

While we do believe MySuper trustees should be subject to higher duties, we do not accept that MySuper members should have their interests prioritised over that of any other member of the same fund on a comparable basis.

Instead, the existing *Superannuation (Industry) Supervision Act 1993* Section 52(2)(c) should continue to apply to all members in a fund. Section 52(2)(c) presents an obligation for the trustee: “to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries.”

RECOMMENDATION: MySuper members should not have their interests prioritised over that of any other member of the same fund on a comparable basis. Accordingly, section 29VN(a) should be deleted and the existing SIS provisions should continue to apply.

Scale

The FSC supports the position that trustees of MySuper products should consider scale when setting the business plans and strategy for that MySuper product. However, the Bill requires a trustee to determine scale in comparison to the financial interests of the beneficiaries of other superannuation funds. The imposition of an external scale assessment that is very broad, unclear and subjective in proposed sections 29VN(b) and (c) will expose trustees to liability.

The FSC does not support a determination of scale by comparison to MySuper products in other superannuation funds. A process based test consisting of a finite list of internal factors for trustees to consider would be preferred. The test should be based on maximising member returns without any external comparison.

The obligation to determine sufficiency of scale by reference to “other funds” that have a MySuper product may be difficult for a trustee to determine as it will not hold this information and so will not have sufficient information about the financial interests of beneficiaries of other superannuation funds in order to undertake a comparison exercise.

It is not clear how a trustee will have information about other MySuper products to be able to undertake the required comparison and make an informed determination. For example, tailored MySuper products are not open to the public and only limited information should be made broadly available due to the bespoke workplace design of these products, as well as in recognition of employer and marketplace sensitivities.

Even for publicly offered MySuper products, it is expected that the information required for a trustee to make an informed determination about the effect of scale in relation to that MySuper product would not be available. For example, the trustee of a MySuper product may need information about other MySuper products that is confidential or commercially sensitive – such as information about the arrangements between the trustees and their service providers.

It is also not clear if the trustee must consider every other MySuper product when making its determination about the sufficiency of scale. If a trustee is not required to consider every other MySuper product, it is not clear how many comparisons must be made in order to meet this duty.

Accordingly, the imposition of a scale test determined by reference to external factors not one that trustees can comply with.

Also, the reference to the term "insufficient" in section 29VN is a vague and imprecise concept that will be difficult to apply with any certainty. This unnecessarily exposes MySuper trustees to potential liability to members.

Furthermore, whilst the obligation is for the trustee to make a determination as to the sufficiency of scale, it is not clear what the trustee is then required to do if it determines that scale is not sufficient. This will be particularly important for a MySuper product that is newly established and is still building its members and assets.

An unintended consequence of these requirements is that trustees of MySuper products may feel obliged to chase scale at the expense of other factors that are valuable to members – such as better service, better insurance and reduced risk.

Another unintended consequence may be the convergence of MySuper products towards the same fees, same investments, and same insurance as each adjusts towards the others as a result of comparative scale determinations.

Finally, if the objective is to promote mergers, there are factors beyond the trustees' control such as tax provisions (CGT) and ACCC considerations which could make the duty impossible to meet.

RECOMMENDATION: The proposed scale test should be removed. Failing removal it should be amended to provide for an entity level non-comparative test that allows a trustee to also consider a finite list of other relevant factors.

<u>Indemnification of trustee from assets of entity</u>

Proposed s56(2A) of the Bill sets out that "A provision in the governing rules of a registrable superannuation entity is void in so far as it would have the effect of allowing a trustee of the entity:

(a) to indemnify itself out of the assets of the entity for any amount expended out of capital of the trustee managed and maintained by the trustee to cover the operational risk of the entity; or

(b) to indemnify itself out of any assets of the entity that do not form part of a reserve maintained for the purpose of covering the operational risk relating to the entity, any amount that relates to that risk, without first exhausting the reserve and any other financial resources managed and maintained by the trustee to cover the risk."

The FSC is concerned that this provision will result in perverse outcomes that are contrary to member interests.

The above provisions refer to the amounts of capital/reserves "managed and maintained by the trustee". Clarity should be given as to whether these references are intended to be references to amounts the trustee holds in its capacity as the trustee or assets the trustee holds in its personal capacity. Clarity should also be given as to what matters require access to the operational risk reserve and what are operational costs that can be paid out of the fund in the ordinary course.

Further, although paragraph 1.81 of the Explanatory Memorandum attempts to explain "operational risk" in terms that indicate trustee fault, the absence of a definition in the draft legislation makes it possible that "operational risk" may include events where the trustee is not in any way at fault but still incurs cost in addressing the event. If so, the proposed prohibition on a trustee recouping such costs from fund assets will mean that a trustee is effectively a guarantor against all "operational risk" – unless the trustee maintains a fund reserve.

Proposed s56(2A) also appears to require trustees using capital (rather than reserves), to exhaust that capital completely in an operational risk event or events while also preventing them from 'topping up' that depleted capital from member/fund amounts. The differential treatment allowing a trustee to maintain an operational risk reserve from fund assets and to replenish that will encourage trustees to do either or both of the following:

- maintain the bare minimum of financial resources to cover risk so that those resources are more quickly exhausted; and
- maintain excessive operational risk reserves rather than meet costs from their own resources and then seek to recoup from fund assets.

Both of these outcomes would be contrary to the intention behind the legislation. A trustee will want to quarantine a risk reserve in liquid and low-risk investments (e.g. cash or cash-like investments). Such investments are likely to yield a lower long-term return. The larger the risk

reserve quarantined in such investments, the less will be the return to investors in the long-run.

RECOMMENDATION: Item 17 and proposed s56(2A) should be omitted from the Bill.

4. COVENANTS FOR RSEs

Diversification

The FSC supports MySuper comprising a single diversified investment option and 'Choice' permitting a wide range of appropriate investment options. We also support the proposition that each public offer RSE should be subject to a diversification requirement at the fund level. That is, a trustee is obligated to present the opportunity for a member to diversify their investment in the fund.

Critically, this obligation should be applied differently across MySuper and choice segments. We do not believe the diversification requirement should extend from the fund / entity to the investment option level (except in the case of MySuper).

As highlighted in the EM, the ability for members to direct investments provides flexibility but it can also lead to a level of control for the member for which the trustee cannot be responsible. For example, the increasing popularity of direct equities chosen by engaged members.

The extension of the existing superannuation investment covenants to each individual investment option (section 52(6)(a)) means that trustees would have an obligation to investigate each listed equity. Unfortunately the obligations are impractical for certain choice product investment options such as listed equities. For example, concepts such a liquidity and diversification are not applicable to individual listed equities and term deposits.

The existing ASX investment governance framework that applies to listed corporations is already of a very high standard, and trustees should be able to rely on this without a separate governance framework.

RECOMMENDATION: Amend section 52(6) by removing references to 'each investment option offered' to allow trustees to continue to offer members investment choice and allow the member to create their own diversified portfolio.

Risk Covenants

The Bill also refers to the exemption from *AFSL* financial resource requirements for (APRA regulated) RSE licensees which also act as responsible entity for non-superannuation managed investment schemes. The Explanatory Memorandum states at paragraph 1.103 that the Corporations Act will be amended so that RSE licensees that are also responsible entities for managed investment schemes are no longer exempt from the Corporations Act requirements to have adequate financial resources.

The proposal has potentially significant implications in terms of the costs of the financial services industry as it is common for entities to act as a trustee/RSE licencee of an RSE and also as a trustee/responsible entity of managed investment schemes. It is essential that this matter be subject to consultation with stakeholders including industry, as well as a draft regulatory impact statement on the implications released to industry and other stakeholders.

In ASIC's recently released update to Regulatory Guide 166 - Licensing: Financial Requirements (released in draft in November 2011), the document states that 'If you are a body regulated by the Australian Prudential Regulation Authority (APRA), as defined in s3(2) of the Australian Prudential Regulation Authority Act 1998, this guide does not apply to you. (Note: APRA, and not ASIC, imposes requirements for financial resources for bodies it regulates. This applies even if only part of your financial services business is an activity that is regulated by APRA.)'

ASIC do state in the document, however, at paragraph 166.17 that' If responsible entities that are RSE licensees (as defined in section 10 of the Superannuation Industry (Supervision) Act 1993) are required to meet the new financial resource requirements as a part of the Stronger Super reforms, ASIC will consider if amendments to the updated financial resource requirements are appropriate, having regard to ASIC's objective that the financial resource requirements reflect the operational risk of a responsible entity'.

We seek consultation (and the opportunity to review and input into a draft regulatory impact statement) in respect of the Government's proposal to apply both APRA and ASIC capital to dual licenced entities.

The FSC is concerned that changes to the exemption without consultation would create a significant cost and compliance burden (which may impact potentially on fees) that would have a varying effect on different RSEs and REs depending on whether they are subject to both APRA's requirements and ASIC's requirements set out in RG 166.

The avoidance of such regulatory burden is one of the reasons APRA regulated entities were given exemptions from ASIC's financial resource requirements during the AFSL licensing process.

RECOMMENDATION: The Government's proposal to apply both APRA and ASIC capital requirements to dual licenced entities is subject to consultation with stakeholders to assess the capital costs, fee and potential impacts on industry consolidation (and competition).

5. COVENANTS FOR DIRECTORS OF RSE LICENSEES

Section 52A sets out a number of covenants which are taken to be included in the governing rules of a registrable superannuation entity whose trustee is a body corporate. These covenants are covenants by each director of the body corporate (Director Covenants).

The Director Covenants mirror a number of the covenants imposed on the trustee itself under section 52 including:

- the duty to act honestly in all matters concerning the superannuation entity;
- to exercise, in relation to all matters affecting the superannuation entity, the same degree of care, skill and diligence as a prudent superannuation entity director would exercise in dealing with the property of an entity for the beneficiaries of which the prudent superannuation entity director was morally bound to provide;
- to perform the director's duties and exercise the director's powers as director of the corporate trustee in the best interests of the beneficiaries of the superannuation entity; and
- to do all things reasonably practicable to avoid a conflict of their personal interests or their other duties with the interests of the beneficiaries of the superannuation entity and their duties to those beneficiaries.

Importantly, the Director Covenants are deemed to be included in the governing rules for a superannuation fund and directors are deemed to be a party to the governing rules. This mechanism is designed to enable a member to sue a director for breach of a Director Covenant.

Currently the SIS Act operates so that a trustee covenant in subsection 52(2) also operates as a covenant by each director of a trustee to exercise a reasonable degree of care and diligence for the purpose of ensuring that the trustee carries out the covenants in subsection 52(2). The FSC believes that the current mechanism under section 52(8), when applied to the expanded trustee covenants, achieves the policy goal.

The change proposed significantly increases the personal liability of a director of a corporate trustee. The FSC has the following concerns with the approach:

- Inconsistent with Ministerial announcements: In his Stronger Super Information Pack the recommendation from the Cooper Review to create a new statutory office of 'trustee-director' was rejected. However, the Bill effectively creates the office of trustee director that the Government rejected and which has now been reintroduced by in the drafting of the Bill. Accordingly, the Bill is inconsistent with the Government's announced position;

- Provides a far wider set of personal liabilities for directors than under the proposed *Personal Liability for Corporate Fault Reform Bill 2012*;

- Significant increase in personal liability of directors: the Director Covenants operate to establish a direct relationship between director of the corporate trustee and the beneficiary of the superannuation entity, thereby potentially making directors personally liable to beneficiaries;

- Negative impact on decision-making: The FSC is concerned that the increased exposure under the Director Covenants could result in more conservative (and accordingly, inappropriate) decision-making and an unwillingness to take measured and otherwise justifiable risks. Further, it may be that individual directors would take independent legal advice to protect their own position the cost of which would be borne by members.

- Significant departure from current corporations regime: general law operates so that the rights, privileges, duties and liabilities ascribed by law to the company are not ordinarily ascribed to its directors. The Director Covenants circumvent general law by ascribing the corporate trustee covenants to the directors of the trustee company. While the FSC does not dispute the ability of statute to depart from this doctrine, to date statute only departs in the most serious of circumstances (eg trading during insolvency (section 588G of the Corporations Act), share capital transactions causing insolvency (section 588G), payment of improper dividends (section 254T of the Corporations Act) and company debts where the

company has no indemnity from trust assets (section 197 of the Corporations Act). Section 52A departs from this regime by exposing directors even in the ordinary operation of the corporate trustee.

- Moves superannuation 'out of step' with the financial services industry: Corporations are prevalent throughout the financial services industry, however, no other sector of the financial services industry imposes such obligations on individual directors – for example, directors of banks and life companies do not have similar obligations.

- No defence for 'innocent' directors: Boards make decisions collectively and directors are not themselves trustees. However, section 52A imposes obligations on each individual director and equates them to the office of trustee. The difference between the regime imposed by the Bill and how boards operate in practice will have adverse impacts for those 'innocent' directors who have acted appropriately but whose position was in the minority. This is compounded because each director's individual comments at a board meeting are not necessarily recorded in the minutes of the meeting. Accordingly, as a practical matter, it may be difficult for individual directors to establish their 'innocence'.

- Other potential practical consequences of the Director Covenants include the combination of the additional duties of 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. This will deter talented people from accepting directorships of funds and also the risk that the assets of the funds could be dissipated in legal costs of the directors defending such actions.

RECOMMENDATION: The current regime requiring a director of a corporate trustee to exercise a reasonable degree of care and should be maintained. Further individually applicable covenants should be removed from the Bill. Failing removal, the penalty regime for the director covenants should be replaced with one mirroring the penalty regime for a breach of the director duties in the *Corporations Act 2001* (Cth).

The defence for directors and trustees under the proposed new section 55(5)

We recommend that the defence under the existing section 55(5) of the SIS Act should continue to be available where the directors of a corporate trustee and the trustee establish that they have made the investment in compliance with the investment covenants as set out in the proposed section 52(6).

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:

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.

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 all those covenants, then the beneficiary would not have a right to bring an action against the director/trustee for loss or damaged 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.

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 may 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.

We do not think that the proposed section 55(5) should operate in this limited manner, and submit that the section should be amended to clarify how it will operate to account for the fact that a director may not personally have been involved in the making of every investment decision.