Law Council
OF AUSTRALIA

13 March 2012

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

Email: corporations.joint@aph.gov.au

Dear Sir/Madam,

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

I am pleased to enclose a submission prepared by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia on the *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012*.

Due to time constraints this submission has not been considered by the Directors of the Law Council of Australia.

Yours sincerely

Margery Nicoll
Acting Secretary-General

Enclosure

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

Parliamentary Joint Committee on Corporations and Financial Services

Submission by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia.

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The Superannuation Committee (**Committee**) is a committee of the Legal Practice Section of the Law Council of Australia. Its objectives include ensuring that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. It fulfils this objective in part by making submissions and providing comments on the legal aspects of proposed legislation, circulars, policy papers and other regulatory instruments.

In this submission, the Committee provides comments on the *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012* ("**Bill**").

1 Summary

The Committee has serious concerns about some key aspects of the Bill. In particular, the Committee is concerned that, if passed in its current form, the law applying to superannuation fund trustees and their directors will be overly complex and onerous.

The current statutory covenants are based on established trustee duties, which provide context and content for their interpretation. The current covenants relate to the manner in which trustees exercise their powers and discretions and do not relate to the outcome of their decisions. In many cases, the proposed new duties and reformulations of existing duties are unclear. This is partly because their wording departs from existing trustee duties in equity, but also because some of the new covenants take an outcomes-based approach. This will make it difficult for trustees and their directors to comply with, or even to know how to comply with, these duties. It will also expose them to uncertainty and risk. The Committee queries whether there will be any commensurate benefit to members arising from this uncertainty and increased risk.

In order to promote compliance, legislation should be clear and certain. This is particularly the case when personal liability can flow from a breach. Legislation should also be consistent. There are examples where the Bill uses terms found in case law and other legislation, but in slightly different ways. Again, this raises the question of whether differences in language reflect differences in duties or standards.

The Committee also notes that, contrary to the Minister's announcements for the Stronger Super reforms[1] about not proceeding with a separate office of 'trustee director', the effect of the Bill is to impose a separate category of superannuation trustee director duties, creating direct personal liability to members for individual trustee directors. This is likely to negatively impact on the willingness of directors to make decisions that are 'out of the ordinary' together with the industry's ability to attract quality directors. It will also increase the professional indemnity insurance cost for trustee directors to the detriment of members.

The Committee also notes a tendency to use the explanatory memorandum (**EM**) to 'fill in the gaps' left by the legislative provisions themselves. This can be dangerous, however, if the actual words are clear on their face, since generally speaking recourse to extraneous material is only permitted to clarify ambiguity or obscurity.[2] APRA is also given the task of providing much of the detail, which may not always be an appropriate delegation of the legislative function.

[1] Contained in the Information Pack released on 21 September 2011
[2] See *Acts Interpretation Act 1901*, s 15AB(1)(b)

More detail about the Committee's concerns is provided in the following sections of our submission.

2 Enhanced trustee obligations

Section 29VN of the Bill will introduce new and additional obligations for trustees of funds that include a MySuper product, called the "enhanced trustee obligations".

2.1 Duty to promote financial interests of MySuper beneficiaries

Under section 29VN(a), trustees offering a MySuper product will be required to promote the financial interests of the MySuper beneficiaries, in particular 'returns after deduction of fees, costs and taxes'.

While the Committee does not object to an obligation to *pursue* a particular outcome, it has some reservations about how the formulation of this new statutory duty might be interpreted. From a legal perspective, the Committee has concerns regarding the inclusion and use of the words, "promote", "financial interests" and "returns".

The word "promote" is ambiguous. Taken literally, the duty to "promote" returns might be interpreted as requiring trustees to undertake marketing activities that advertise the returns of their investment activities. Alternatively, the duty might be interpreted as requiring trustees to prioritise or to elevate returns (in terms of order of importance), relative to the other considerations which are typically taken into account by trustees (such as risk). Further still, the duty might be interpreted as requiring trustees to undertake activities which have the effect of fostering or improving returns above all other considerations.

The term "financial interests of members" was first used by Sir Robert Megarry V-C in *Cowan v Scargill.*[3] His Honour used it in considering the exercise of the trustees' power of investment, concluding that it:

> "*must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment.*"

There is some danger in extracting a phrase used by a judge to describe a specific duty in the very specific context of a case and then using it to formulate a new obligation of general application.

In *Cowan v Scargill*, Justice Megarry used the phrase to make the point that the trustees in question should have turned their minds exclusively to the members' interests as members of the fund and not to other concerns, such as their job security. His Honour did not mean that the trustees had a duty to obtain the best return for beneficiaries. Further, as the extract from the judgment indicates, Justice Megarry considered that the exercise of the trustees' investment power required the consideration and judgment *by the trustees* about the risks associated with the investments in question, not only potential returns.

The current drafting compels trustees to focus on returns and, if that is the sole focus, MySuper products might end up being "high risk, high return" styled products. In this regard, section 29VN(a) is inconsistent with section 29VN(d)(ii)

[3] [1985] 1 Ch 270

and new sections 52(6)(a)(i) and 52(8) which *do* require risk to be taken into account. It is therefore critical that trustees be *permitted* under section 29VN(a) to take the relevant risks into account (which might involve a trade off from a potential return perspective) and from a policy perspective that they be *required* to take risks into account (especially if there is to be consistency with the provisions referred to above). The 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,[4] but the express focus on 'returns' would suggest otherwise (especially since risk **is** expressly mentioned in section 29VN(d)(ii), but not in section 29VN(a)). This issue could be addressed either by referencing risk in conceptual terms or by specifically referring to "risk-adjusted returns".

Also, because the new duty does not appear to be limited to investment matters, the reference to 'returns' appears to imply that other financial interests – such as costs and insurance interests – are of lesser importance.

Further, the expression 'returns' is not defined by reference to any long term time horizon. This is inconsistent with section 29VN(d)(i). As such, there is a risk that short term investment objectives will be pursued – which is exacerbated by the comparative duties imposed by section 29VN(b).

On balance, rather than requiring trustees to "promote returns", the Committee considers it would be preferable to delete section 29VN(a) altogether and to rely instead on section 52 in relation to the proper formulation of investment strategies and on the proposed MySuper fees and charges provisions in relation to the level of costs being borne by MySuper members. Alternatively, some reference to "10 year risk-adjusted returns" should be included for consistency with other proposed provisions.

2.2 Comparative duty to annually determine sufficiency of fund assets and members

Under section 29VN(b) of the Bill, trustees offering MySuper products will be required to determine, annually, whether the MySuper beneficiaries are disadvantaged in comparison to the beneficiaries of MySuper beneficiaries in other funds because their financial interests are affected because:[5]

- the MySuper assets[6] (or the MySuper assets and assets with which they are pooled) are insufficient; or
- the number of MySuper beneficiaries (or the number of beneficiaries of the fund) are insufficient.

The EM states that these provisions are aimed at ensuring sufficient scale to meet the MySuper costs[7] and that, if the trustee determines that the assets or members are insufficient they will need to take appropriate action, having regard to APRA's prudential guidance**.**[8] Is there to be a timeframe over which the 'disadvantage' may

[4] At paragraph 1.19
[5] The Committee notes that the drafting of this provision uses a double 'because', which makes it clumsy to read.
[6] The Committee assumes the reference to 'MySuper assets' is intended to be a reference to the value of the MySuper assets.
[7] At paragraph 1.23
[8] At paragraph 1.27

be rectified or does the trustee need to immediately proceed to transfer its MySuper members to another MySuper product? APRA's guidance on these matters will be crucial and the Committee queries whether it is appropriate to delegate such an important matter to the regulator.

In measuring disadvantage, the Bill expects trustees to compare their MySuper members' financial interests to MySuper members in all other funds. It is not clear how these financial interests are to be determined. If, for example, "financial interests" are to be measured solely by reference to published returns, this should be clearly stated. However, the Committee notes that crude comparisons of returns between MySuper products may not be particularly helpful since there will always be funds in the lowest quartile. Alternatively, if a broader range of factors can be considered such as member services, these broader factors should be expressly included, rather than leaving it to APRA guidance.

In any case, it is not clear how the comparison would be made. For example, if a fund with 100,000 members is invested in a balanced option and had net return of (say) 5% pa and another fund with 200, 000 members is invested in a riskier investment option and had net returns of (say) 8% pa, can the trustee necessarily conclude that the financial interests of the members of the first fund are disadvantaged in comparison to the second fund? If this requirement had applied immediately before the Global Financial Crisis, members of funds that were safely invested in cash would have wrongly been considered to have been disadvantaged in comparison to funds that were invested in much riskier or illiquid investments.

The Committee also notes that the requirement to assess disadvantage against 'other funds' would be very difficult in practice. It seems to require an assessment to be made against *all* other funds, as there is no basis expressed on which a trustee might select some funds only against which to conduct the comparison.

That said, the Committee queries whether the intention behind 29VN(b) is to encourage fund mergers and consolidations. If this is the case, the drafting should perhaps be more transparent in its intent and focus more directly on the issue of mergers and consolidations and possibly be accompanied by broader reforms that remove the taxation and procedural impediments to mergers and consolidations. An express duty to give to due consideration to any formal proposal to merger or consolidate two funds would be subject to fewer vagaries than a provision that expects the level of funds under management and the number of members to somehow be the mainstay of Australia's retirement income system.

2.3 Recording of annual determination

While the Committee understands the regulatory basis for requiring the details of the trustee's annual determination to be recorded, it is not clear to the Committee why the details should be recorded in the trustee's MySuper investment strategy or how that might be achieved, particularly if the "financial interests" comparison is to include broader factors other than published returns. An investment strategy (at its core) is typically merely a percentage allocation to various asset classes, depicted either as a pie-chart or in chart form. The details contemplated by section 29VN(b) do not lend themselves to being "included" in an investment strategy *per se*, but clearly they are matters that ought to be taken into account in formulating the strategy.

The Committee suggests that, if section 29VN(b) is enacted, section 29VN(c) should simply require the details of the trustee's determination to be recorded.

2.4 Different director standard

Section 29VO(1) requires each director of a corporate trustee to exercise a reasonable degree of care and diligence to ensure that the enhanced trustee obligations are met. However by virtue of sections 29VO(2) and (3), a reasonable degree of care and diligence is determined by reference to the care and diligence that would be exercised by a person whose profession, business or employment includes acting as a director of a corporate trustee and investing money on behalf of superannuation fund beneficiaries (defined as a 'superannuation entity director'). This is in contrast to the current terms of section 52(9) of the SIS Act, which refers to a 'reasonable person in the position of the director'.

The new concept effectively means that each director must meet the standard of a professional superannuation trustee director, which is a different standard than the 'prudent person of business' standard announced in the Stronger Super reforms. As a practical matter, it may be difficult, if not impossible, for a person new to directorships and/or to superannuation to meet the required standard. In turn, this throws doubt on the on-going viability of equal representation, in particular board structures that provide for member-elected directors.

The EM suggests that some flexibility will be permitted (and that this standard is intended to align with the State Trustee legislation)[9] but as discussed later in this submission, the Committee wonders if that alignment is misconceived.

The Committee recommends that the director standard reflect the prudent person of business standard.

Given the prominence and frequent use of investment sub-committees to formulate investment strategies, in our view there should also be a provision which expressly contemplates and permits the delegation of investment decisions to appropriately constituted committees (and reliance upon committee decisions) for the purposes of fulfilling the obligations arising under section 29VO.

2.5 Liability for breach of enhanced trustee duties

Section 29VP allows persons who suffer loss or damage because of a contravention of section 29VN or section 29VO to recover their loss from a person involved in the contravention. In the context of MySuper, this seems likely to invite class actions, particularly over 'net returns' that are in the bottom quartile, and to encourage an unhelpful and inappropriate analysis of individual directors' qualifications and experience with a view to founding such actions. The costs of defending such actions and paying any damages to litigants will ultimately be borne by members, either directly or through increased fees.

More fundamentally, it seems inappropriate to impose civil liability for breach of these new enhanced trustee duties, which are more akin to statutory obligations than to fiduciary covenants. Indeed, the new enhanced trustee obligations duties bear no resemblance to trust law duties. As such, the penalty for their non-compliance should be purely statutory, such as withdrawal of the trustee's RSE authorization or the imposition of penalties and fines. In our view, trustees and

[9] At paragraph 1.62

directors should not be exposed to civil suit for losses in respect of these type of duties.

The Committee objects to the imposition of civil liability on trustees and directors in respect of the enhanced trustee obligations, particularly given their uncertainty.

3 The new trustee covenants

The Bill will repeal the existing trustee covenants in section 52 of SIS and replace them with general covenants (section 52(2)), investment covenants (section 52(6)), insurance covenants (section 52(7)) and covenants relating to risk (section 52(8), which will replace the relevant RSE licence conditions requiring a risk management strategy and risk management plan). In addition, new section 52A will impose express covenants on directors of trustees and section 52B will create separate although overlapping covenants for trustees of self-managed superannuation funds.

3.1 General covenants

The governing rules of registrable superannuation entities (**RSE**s) will be taken to include eleven "general" covenants. In addition to the core existing covenants to act honestly, to exercise care, skill and diligence (although the standard has been changed) and to perform the trustee's duties and exercise its powers in the best interests of the beneficiaries, there are new covenants.

Trustees will now also be required:

- 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;[10] and

- to act fairly in dealing with classes of beneficiaries and beneficiaries within a class.[11]

Standard of care

The standard of care skill and diligence in section 52(2)(b) has been changed from what "an ordinary prudent person would exercise in dealing with the property of another for whom the person felt morally bound to provide" to what "a prudent superannuation trustee would exercise in relation to an entity of which it is the trustee *and on behalf of the beneficiaries of which it makes investments*". The Committee makes a couple of observations about this change:

- A "prudent superannuation trustee" is a concept unknown to equity.[12] In the Bill, a superannuation trustee is defined as a person whose profession, business or employment is or includes acting as a trustee of a

[10] Proposed section 52(2)(d)
[11] Proposed sections 52(2)(e) and (f)
[12] Equity refers to the 'prudent person of business': see, eg *Australian Securities Commission v AS Nominees Ltd* (1995) 133 ALR 1, 12

superannuation entity and investing money on behalf of beneficiaries of the superannuation entity.[13]

- The proposed formulation of the standard omits the reference to 'moral obligation' – which is arguably that part of the standard importing a requirement of caution, since a prudent person would be even more cautious in dealing with property of another person to whom he or she owes a moral obligation. Yet the EM states that the new standard is 'higher'.[14]

- The proposed formulation seems to import notions of collective agency through the use of the words 'investing on behalf of the beneficiaries'. The EM states that the changes are intended to align the standard with existing State and Territory legislation.[15] For example, section 6(1)(a) of the *Trustee Act 1958* (Vic) provides:

  Subject to the instrument creating the trust, a trustee must, in exercising a power of investment -

  (a) if the trustee's profession, business or employment is or includes acting as a trustee **or** investing money on behalf of other persons, exercise the care, diligence and skill that a prudent person engaged in that profession, business or employment would exercise in managing the affairs of other persons; or

  (b) if the trustee is not engaged in such a profession, business or employment, exercise the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons.

  As such, paragraph (a) of section 6(1) would impose the same 'professional' standard whether the person is a trustee of a trust **or** an agent investing on behalf of others. The Committee would argue that in the superannuation context, where there is no doubt that the trustee acts as trustee,[16] the additional words "on behalf of the beneficiaries of which it makes investments" add nothing. When read together with the definition of 'superannuation trustee', the additional words also create duplication and confusion.

In the Committee's view it would be preferable for the Government to use the equitable 'prudent person of business' standard, as was foreshadowed in the Stronger Super reforms.

Duty of priority

In the Committee's opinion, the new duty of priority will make bad law – it is difficult to understand, does not accurately reflect the trustee's equitable duties and, in some cases, will be impossible to comply with.

Oddly, given the Government's intention to increase standards which apply to superannuation trustees, the duty of priority may well lower it in some cases. In other cases it will be impossible to comply with. The duty appears to give

[13] Proposed section 52(3)
[14] See paragraph 1.46
[15] At paragraph 1.62
[16] SIS Act, s 19(2)

permission to trustees to act with a conflict of interest or duty where they are not able to do so now (without consent). However, in acting with a conflict of interest or duty, they must give priority to the interests of beneficiaries. Where a trustee has competing duties (eg to different beneficiaries) it will not be possible for it to give priority to both.

The "duty of priority" as a concept has gained prominence in other current legislative reforms, but it is extremely unclear what a trustee is required to do in order to discharge the duty. There is no body of law to assist trustees, which may lead to difficulties, risks and costs. The new covenant seeks to resolve this uncertainty by a delegation to APRA under its new prudential standards making power. It is curious to single out 'conflicts' in this way, given that APRA is expected to make prudential standards on a great variety of topics.[17]

More fundamentally, the trustee is required to "ensure" that certain outcomes are achieved – meeting the trustee's duties and not disadvantaging beneficiaries. While those outcomes are entirely laudable, the structure of this duty is inconsistent with trust law's focus on the proper process for trustee decision-making.

The Committee recommends that the requirement to achieve certain outcomes be amended to reflect that the trustee must have processes in place that are designed to achieve those outcomes.

Reserving strategy

With regard to section 52(2)(j), the drafting requires the strategy for investing reserves to be consistent with the investment strategies of the fund. This is problematic for several reasons and will be important to rectify, given the increasing focus and reliance upon operational risk reserves in future. For funds offering multiple options and that therefore have multiple investment strategies, it is unclear which investment strategy the reserve strategy must be consistent with. Clearly it would be impossible for the reserve strategy to be simultaneously consistent with all of those investment strategies.

In the Committee's view, there is no particular reason why the strategy for managing reserves should be consistent with any of the strategies underpinning the fund's investment options.

3.2 Overriding effect of duties

The Committee notes that proposed sections 52(4) and 52A(3) purport to override any conflicting duties of an executive officer employee or director under Part 2D.1 of the Corporations Act.

The Committee queries whether any conflicting duties of the directors under Part 2D.2 (relating to indemnity and insurance) should also be overridden. The Committee also suggests that the drafting make it clear that the conflicting duties of directors arising at general law are also overridden.

[17] See APRA Discussion Paper, September 2011

3.3 The investment covenants

The Bill introduces more extensive investment covenants which will apply when a trustee formulates, regularly reviews and gives effect to an investment strategy. They now include considering whether reliable valuation information is available and the expected tax consequences. The Committee agrees that valuation information and tax consequences are relevant considerations that a trustee acting properly will already take into account when formulating an investment strategy and does not have any general concern with including these additional matters in the investment covenant.

The Committee does note, however, that section 52(6)(a)(iv), which requires regard to be had to the availability of "reliable valuation information", may limit the ability of trustees to invest in some types of assets, such as those that are valued by reference to the manager's own valuation as this may not be considered 'reliable'. It is unclear from the drafting whether, in the case of investments in pooled funds, it is sufficient for the trustee to have reliable valuation information concerning its direct investment in the pooled fund, or whether the intention is to require trustees to have reliable valuation information concerning the underlying investments made by the pooled fund (or the investments made by the entities in which the pooled fund invests, and so on). The latter is likely to be problematic from a practical perspective (if that is indeed the intention), given that any look-through must eventually cease at some point and ultimately trustees must have the benefit of reasonable reliance upon the managers of pooled funds. The Committee therefore suggests that the drafting expressly refer to valuation information for direct investments.

The Committee is concerned about the requirement to formulate an investment strategy for 'single asset' investment options (which by their nature are not diversified) and about the new covenants in section 52(6)(b) and (c). They require trustees to exercise due diligence in developing, offering and reviewing investment options and to ensure that the investment options offered to beneficiaries allow adequate diversification. In the Committee's opinion, the scope of a trustee's duty to offer and review investment options should be dependent upon the nature of the fund. Many members of "wrap style" superannuation products join those products so that they can nominate their own investments from the widest range of investments available. These new duties may well limit the ability of trustees to offer wrap style products or even funds with multiple investment options. Complying with the new duties will be onerous and costly. Further, trustees will be exposed to a degree of uncertainty about whether they have undertaken sufficient due diligence or reviewed sufficiently regularly the investment options offered.

Further the wording of section 52(6)(c) is unclear. The EM indicates that a member should be able to select a diversified strategy if they wish, but the drafting could be read as requiring *every option* offered to be diversified.

At the very least, proposed section 52(6)(c) should be modified to permit trustees to have regard to direct or indirect diversification.

This would at least facilitate the offering of investment options that comprise an investment in a single pooled fund, which in turn invests in a diversified portfolio of investments. For example, a fund might offer an "international shares" option that is implemented by investing in a particular registered scheme. In this case, even though the option may appear to lack diversification on account of being wholly

invested in a particular scheme, the underlying portfolio might be well diversified across thousands of underlying securities.

The Committee also considers that, in the context of a choice fund, these new obligations are inconsistent with the recommendations of the Cooper Review whereby trustees would assume greater responsibility for default fund members (now MySuper members) and would have fewer obligations with respect to choice members - these members being informed and wanting to control their own superannuation. Instead, Stronger Super generally and the investment covenants in particular will require trustees to assume more responsibility for members across both the MySuper and choice sectors.

The Committee recommends that, in the context of choice members, the additional obligations under sections 52(6)(b) and (c) should be removed.

3.4 Insurance covenants

The drafting of this covenant is not clear, and might be read as requiring all funds to provide at least some insurance.

In section 52(7)(c), the requirement to avoid inappropriate erosion of retirement income through insurance costs is unclear - there is no indication as to what 'inappropriate erosion' would be, or how a trustee might assess whether this is the case. The Committee submits that section 52(7)(b) could stand on its own without 52(7)(c), and that the omission of (c) will not substantially alter the protective effect for members.

The Committee recommends the deletion of section 52(7)(c).

In section 52(7)(d), the reference to 'a reasonable prospect of success' is unclear. It seems to impose an objective test, but given that the trustee must determine whether to pursue a claim at the expense of the fund as a whole, it should refer to the trustee's subjective opinion. Further, there are other factors the trustee should take into account, such as the likely costs and risks of taking action. As drafted, it seems that a trustee would have to take proceedings over a $5,000 claim even if it thought the best case scenario would be unrecoverable costs of $50,000. Presumably this is not intended.

The Committee considers that section 52(7)(d) should be modified to say "if, *in the opinion of the trustee*, the claim has a reasonable prospect of success" and to remove any suggestion that the trustee owes an individual duty to the claimant over and above its duty to members as a whole.

4 Covenants for directors

While the Government has said that it did not support the recommendation for a new role of trustee/directors, the Bill will create one. In addition to their existing duty to exercise a reasonable degree of care and skill to ensure that the trustee complies with its covenants,[18] under new section 52A each director will have direct and personal duties, mirroring the trustee's covenants, to each and every member of a superannuation fund. This is because the new director covenants are

[18] By virtue of section 52A(5), a reasonable degree of care and diligence is determined by reference to the care and diligence that would be exercised by a superannuation entity director in the circumstances. This term is defined in section 29VO.

deemed to be included in the fund's governing rules and, under section 55(3), someone who suffers loss or damage as a result of person breaching a covenant may recover the amount of that loss or damage from that person (and anyone else involved in the contravention).

Given the rate of consolidation of superannuation funds and their anticipated size, this means that a director of a large industry or retail fund can expect to owe duties (and potentially be personally liable to) millions of members.[19]

The potential for legal action to be taken directly against a director by anyone of such a large number of people is inconsistent with the duties (and potential liability) of directors of other financial services entities (such as banks, life companies and managed funds), which are of comparable or even greater size.

What is more, in many cases, the proposed new duties are unclear and some again adopt an outcomes-based approach. In order to attract quality directors to superannuation trustee boards, these directors need to have confidence that they understand their obligations and will be in a position to satisfy them. If the Bill is passed in its current form there is a real question as to whether suitably qualified candidates will be willing to take on superannuation trustee directorships and whether existing directors will be willing to continue in their roles. The pool of suitably qualified directors is currently quite small and shrinking. The Bill may narrow this pool even further.

4.1 General objections

The Committee submits that the imposition of these personal trustee director duties as proposed would have an undesirable result, for the following reasons:

Boards make decisions as a collective: In the Committee's view, Boards make decisions collectively, and individual directors acting alone will not be in a position to make a decision in respect of any matter. Individual directors are not trustees. It should also be remembered that those Boards which are structured according to the SIS Act equal representation rules require a two-thirds majority for resolutions to be passed.

Negative impact on decisions that are 'out of the ordinary': The threat of direct member action over matters such as whether decisions on investments have been made in the best interests of the beneficiaries may result in changed behaviour at board level, such as an increased reliance on expert reports and input (at further cost to members), an unwillingness to deviate from what is seen to be 'standard' practice among funds or to take measured and justifiable risks, and an increased demand by directors to take separate independent legal advice (again, in many cases ultimately at a cost to members).

Misuse of process: Even a typical disputed disablement claim will generally involve an allegation of breach of trust by the trustee in failing to pay the claim in accordance with the trust deed. If such allegations could be made directly against the directors themselves, it seems likely that members would include directors in any proceedings brought against the trustee, simply to make sure that they 'cover the field'. This would most likely add to the cost to funds of dealing with member litigation, without providing any corresponding protection or benefit to members.

[19] It should be noted that the 4 largest superannuation funds have between 750,000 to 2.5 million members in each fund (approximately 6.7 million members in total).

A culture may develop in which members are encouraged to pursue actions against directors in situations where, for example, returns have been disappointing. Should that happen, directors and management will need to take time away from more productive matters to address these actions, to the potential detriment of members. It also seems likely that any damages ultimately awarded would be payable by the trustee from its own resources (in which case fees charged to members might have to rise) or from the fund (in which case there is a cost to all members). This may effectively result in a transfer of fund assets from one group of members to another, with resulting inequity arising as between members.

Relativities with duties and liabilities of directors of other entities: It has been suggested that exposure to personal liability which is not present in other financial institutions would make it harder for the superannuation industry to attract quality and suitable candidates for directorship. The Committee notes that directors of a superannuation fund would be placed in an adverse position as regards liability when compared against, for example, directors of banks. As a parallel, under Chapter 5C of the Corporations Act, officers of a responsible entity have direct duties by virtue of section 601FD, but civil liability does not attach to these duties. Civil liability only attaches to a breach of duty by the responsible entity itself.[20]

Increase in professional indemnity and D&O insurance costs: Directors and Officers insurance premiums may rise to take account of the increased risks. Ultimately, such costs are passed on to members through higher fees or because costs are a direct expense of the fund.

The Committee is not aware of any research or other evidence suggesting that the avenues of redress already available if directors are thought to have breached their obligations are insufficient.

The Committee strongly urges the removal of personal liability for individual trustee directors.

4.2 Specific comments

Under the proposed new duties, directors will be required to:

- act honestly;
- exercise care, skill and diligence of the standard of a prudent 'superannuation entity director';
- perform the director's duties and exercise the director's powers in the best interests of the beneficiaries;
- where there is a conflict, give priority to the duties to and interests of beneficiaries; and

[20] Corporations Act, s. 601MA

- not enter into a contract or do anything else which would prevent the director or the trustee from performing or exercising their functions and powers.

Although these covenants do not fully align with a director's duties under Part 2D.1, the covenants are said to override those duties to the extent of any inconsistent obligation.[21] They are also said to operate "as if the director were a party to the governing rules".[22]

The Committee queries whether section 52A(1) would actually have any effect from a legal perspective. Directors of a trustee company are not usually parties (ie signatories) to the trust deed governing a superannuation fund. From a legal point of view, deeming a trust deed to include provisions will not (on its own) have the effect of creating binding obligations on persons who are not parties to the document. In this regard, the Committee notes that the directors are deemed to be parties under section 52A(6), but queries whether this 'double deeming' will have the desired legal effect.

In any event, all of the problems referred to in section 3.1 above will apply even more acutely to directors .As with the enhanced trustee obligations, the new concept of a 'superannuation entity director' effectively means that each director must meet the objective standard of a professional, although the EM says that this standard need not be achieved immediately. In addition, the standard of care skill and diligence is even more clumsily expressed in proposed section 52A(2)(b). This wording could be greatly simplified by referring to the 'care, skill and diligence that a prudent superannuation entity director would exercise in relation to an entity where he or she is a director of a superannuation trustee'.

The problems discussed above in relation to the new outcomes-based duty of priority are even more acute in the context of a director. As an example, imagine that a director has a conflict of duty because he or she is also a director of an administration company tendering to provide administration services to the fund. The proper process for managing such a conflict would be to absent oneself from the decision. Imagine, however, that, having declined to participate in the decision, the administration company is appointed by a decision of the remaining directors and the company fails to properly administer members' accounts causing irrecoverable overpayment of benefits to the detriment of remaining members. The interests of members may have been adversely affected by the director's conflict if it led to the administration company being appointed, when perhaps if the director had participated he or she may have had information that could have helped the remaining directors make a better decision. Would the director be in breach of the covenant and potentially personally liable in this situation?

Further, while APRA's standards about what a director should do to give priority to members' interests will be relevant, those standards will not completely define the director's legal responsibilities. Whether or not a director has breached these new duties will ultimately be determined by a court and could lead to personal liability for directors. Given that directors will need to obtain professional indemnity insurance for these new duties, it is at least incumbent on the government to ensure that they are clear and certain.

[21] Proposed section 52A(3) – in this regard, it is unclear if directors would still have the benefit of the 'business judgment' defence under the Corporations Act
[22] Proposed section 52A(6)

However, the Committee would argue for the removal of civil liability for directors altogether. As stated above, directors of responsible entities are not directly responsible for losses to members. Rather a breach of the section 601FD duties is a civil penalty provision. Further, in keeping with the principles approved by the Council of Australian Governments (**COAG**) to harmonise personal liability on directors, the *Personal Liability for Corporate Fault Reform Bill 2012* proposes to remove personal liability for intentional and reckless involvement in a breach of the responsible entity's duties and rely instead on standard legal principles governing accessorial liability. As such, to create direct civil liability for losses suffered by members from a breach of the proposed director covenants would seem to be going 'against the grain' of the COAG principles.

The Committee strongly objects to the imposition of civil liability for a breach of the new director covenants.

5 Defence under section 55(5) watered down

Currently trustees who follow the investment direction of a beneficiary, are protected from an action from the beneficiary for loss or damage under section 55(5) provided that the investment was made in accordance with an investment strategy formulated under section 52(2)(f). This defence will be significantly reduced to apply only where the defendant has complied with:

- all of the covenants (and not just the covenant in relation to formulating and giving effect to an appropriate investment strategy); and
- for a MySuper beneficiary, the enhanced trustee obligations in relation to MySuper,

that apply to the defendant in relation to the investment.

For MySuper members, the Committee queries whether trustees will be exposed to potential class actions for failing to promote the financial interests of members if their returns are in the bottom quartile.

The Committee also queries whether the dilution of the defence is appropriate for choice members. Also, as drafted, this would have the effect that a defendant would lose the ability to rely on the defence if there had been even a trivial or immaterial breach of a covenant and even if that trivial breach has no bearing on the loss or damage. The Committee therefore submits that there should be a materiality test. Otherwise class action litigants would be encouraged to undertake extensive and costly discovery aimed at finding some minor breach that could be used to deny the trustee's defence.

More generally, however, the Committee is not aware of any evidence suggesting that the existing defence has been abused. It seems to the Committee fundamentally unfair that a trustee or director who has acted in good faith and for a proper purpose in performing his or duties under one covenant should not be able to rely on the statutory defence where it is later found that there has been some breach of another covenant. The EM states that the changes are not intended to prevent trustees from accessing the defence where a covenant or duty is not relevant to the particular loss,[23] but this is not readily apparent from the revised wording of section 55(5). In any event, it is difficult to see how this diluted defence

[23] At paragraph 1.82

provides any real protection since if a trustee or director has complied with all applicable covenants, it is difficult to envisage how an actionable claim for loss could arise.

The Committee supports the retention of the current wording for the statutory defence (expanded to cover directors if personal liability for the proposed trustee director duties is retained).

6 Trustee's right of indemnity

Under proposed section 56(2A), a trustee's right of indemnity from fund assets will be restricted so that the trustee:

- will not be able to recover from the assets of the fund amounts which are paid from trustee capital maintained to cover operational risk of the fund; and

- must exhaust the operational risk reserve maintained in a fund and its other financial resources maintained to cover the risk (namely, trustee capital) before being indemnified from the other assets of the fund for the costs of operational risk.

Both sections 56(2A)(a) and (b) refer to amounts "managed and maintained by the trustee". It is unclear whether these references are intended to be references to amounts held by the trustee in its capacity as trustee (ie amounts that are technically fund assets) or assets held by the trustee in its personal capacity. This should be clarified. The Committee suspects the intention must surely be to refer to amounts held by the trustee in its capacity as trustee, because it would be unfair to restrict access by trustees to a separate reserve of their own personal assets for uninsured risks.

In any event, it is not clear how a trustee is to determine what matters require access to the operational risk reserve (which must be exhausted before resort is had to the remainder of the fund), and what are simply operational costs to be paid out of the fund in the ordinary course. 'Operational risk' is not defined in the Bill, although the EM does describe it as "the risk that a superannuation fund may suffer loss due to inadequate or failed internal process, people and systems or from external events".[24] Given that this represents a potential fetter on the way trustees may access their right of indemnity, it is incumbent that the legislation provide clarity rather than leaving it to the EM or APRA in a prudential standard.

In the Committee's view, the distinction between operational risk and general operating costs must be clarified, eg through defining "operational risk".

7 Prudential standards

The Bill will introduce a new Part 3A into SIS. It will set out APRA's prudential standards making powers.

[24] See paragraph 1.99

7.1 Different standards may apply to different classes or different trustees

Under new section 34C(1), APRA will be able to make prudential standards that must be complied with by all RSE licensees, specified classes of RSE licensees or an individual RSE licensee. Similarly, APRA's prudential standards can apply to one or more "connected entities" (which is defined to include a subsidiary of the RSE licensee and any other entity of a kind prescribed by regulation).

The Committee has some reservations about the proposed power for APRA to make a prudential standard which applies to a single RSE licensee. This will allow APRA to apply special rules to individual trustees or to their connected entities, subject to the ability to request a review of the decision. While the Committee notes APRA's desire to be able to tailor standards to particular circumstances, it is concerned about how this power could be used in practice.

The very notion of a prudential standard that applies to an individual seems incongruous. In this regard the Committee notes that individual prudential standards will not be legislative instruments[25] and will be reviewable.[26]

In the Committee's view it would be preferable for APRA to have a directions-making power if it wishes to impose particular requirements on single RSE licensees, rather than persisting with the somewhat confusing concept of an individually applied prudential standard.

7.2 Prudential matters

The definition of 'prudential matter' seems to cover every possible aspect of the running of a fund and is much broader than the definitions applying to the banking and insurance sectors. Interestingly, in this context, sections 34C(4)(a)(i) and 34C(4)(b)(i) refers to the 'interests' of the beneficiaries' rather than their 'financial interests' and the Committee wonders whether this is intended. The Committee also queries how the 'reasonable expectations of the beneficiaries' referred to in sections 34C(4)(a)(ii) and 34C(4)(b)(ii) are to be ascertained.

Given that the corresponding definitions of 'prudential matter' under e Banking and Insurance legislation do not include references to reasonable expectations of account or policy holders, the Committee considers that sub-paragraph (ii) relating to the reasonable expectations of beneficiaries should be deleted from sections 34C(4)(a) and (b).

The Committee notes that there appears to be a drafting error in the wording of section 34C(4)(f) – it is assumed that the words 'with integrity, prudence and professional skill' are intended to qualify the word 'conduct' but this could be made clearer.

The Committee would be pleased to discuss its concerns in greater depth. At first instance, please contact the Chair of the Committee, Ms Heather Gray on 03 9274 5321, heather.gray@dlapiper.com - or in her absence, the Deputy Chair, Ms Pamela McAlister on 03 9603 3185, pam.mcalister@hallandwilcox.com.au.

[25] Proposed section 34C(8)
[26] Item 9 of Part 2 – Consequential amendments

Attachment A: Profile of the Law Council of Australia

The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its constituent bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Large Law Firm Group, which are known collectively as the Council's constituent bodies. The Law Council's constituent bodies are:

- Australian Capital Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Independent Bar
- The Large Law Firm Group (LLFG)
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of approximately 56,000 lawyers across Australia.

The Law Council is governed by a board of 17 Directors – one from each of the constituent bodies and six elected Executives. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive, led by the President who serves a 12 month term. The Council's six Executive are nominated and elected by the board of Directors. Members of the 2012 Executive are:

- Ms Catherine Gale, President
- Mr Joe Catanzariti, President-Elect
- Mr Michael Colbran QC, Treasurer
- Mr Duncan McConnel, Executive Member
- Ms Leanne Topfer, Executive Member
- Mr Stuart Westgarth, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.