Law Council
OF AUSTRALIA

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

Parliamentary Joint Committee

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

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SUBMISSION ON THE EXPOSURE DRAFT OF THE *SUPERANNUATION LEGISLATION AMENDMENT (FURTHER MEASURES) BILL 2012*

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

The Law Council of Australia is the peak national representative body of the Australian Legal Profession and represents some 60,000 legal practitioners nationwide. The Superannuation Committee (the Committee) is a committee of the Legal Practice Section of the Law Council of Australia. The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. The Committee fulfils these objectives in part by making submissions and providing comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments that affect regulated superannuation funds.

In this submission, the Committee provides comments on the exposure draft of the *Superannuation Legislation Amendment (Further Measures) Bill 2012* (the Bill) recently released by Treasury.

The Committee would be pleased to discuss its submission in greater depth and to provide any further information to Treasury in respect of the submissions made.

In the first instance, please contact the Chair of the Committee, Heather Gray on 03 9274 5321, heather.gray@dlapiper.com – or, in her absence, the Deputy Chair, Pamela McAlister on 03 9603 3185, pam.mcalister@hallandwilcox.com.au

1. KEY THEMES

The key themes identified by the Committee are:

- Some drafting changes are needed in the tied service provider provisions so that they do not unintentionally remove a trustee's powers;
- In relation to infringement notices, some more detail is required within the notices and also further thought should be given as to whether a trustee can be indemnified in relation to an amount payable under an infringement notice;
- Time limits for the requesting of reasons should be imposed;
- Further clarity around the threshold for a court granting leave for actions to be taken against directors is needed, and serious reconsideration of the section 55(5) and 55(6) defences is warranted; and
- There has been a material change of principle in relation to the wording change in section 29WA(1)(c), which should be acknowledged to avoid confusion for those who have designed their MySuper products based on the previous wording.

The Committee's recommendations in respect of each relevant part of the Bill are highlighted in underlined italics.

2. STRUCTURE OF SUBMISSION

The Explanatory Memorandum to the Bill is structured into six chapters. The Committee's comments on the Bill are organised in the same order as those chapters:

- Chapter 1: Service providers
- Chapter 2: Infringement notices

- Chapter 3: Reasons for decisions and SCT time limits
- Chapter 4: Dual regulated entities
- Chapter 5: Actions for breaches of directors' duties
- Chapter 6: Other measures and consequential amendments

3. SUBMISSIONS

3.1 Chapter 1: Service providers

a) **"May or must":** The Committee understands that proposed section 58A is intended to cause a provision in a fund's governing rules to be void to the extent that it *requires* a trustee to use a particular service provider or investment entity or purchase a particular financial product. However, in each relevant sub-provision there is no concept of "to the extent that" and also the wording "may or must" is used.

We note that the EM has been amended to explain why the provisions include the word “may”. It says at paragraph [0.12] that “This is to ensure that the requirements of the provisions cannot be avoided through a clause that confers power to use particular named entities which might have the effect of encouraging or sanctioning the use of these entities instead of considering other options in the market”.

This would not be the effect of such a provision. A provision in a trust deed which authorises a trustee to, say, invest in a life policy issued by a named person or any other investment does not relieve the trustee of its obligation to consider an appropriate range of investments. The provision may have been included, not so as to avoid the trustee considering other investments, but rather to give permission to the trustee to invest in a policy issued by a person which might otherwise be prohibited, for example because of a conflict of duty or interest where the life company is related to the trustee.

Instead of “restor[ing] a trustee’s discretion to act in the best interests of beneficiaries (see paragraph [0.8] of the EM), the use of the word “may” in section 58A may have the effect of removing the trustee’s relevant powers. For example, if a trust deed provision specifies an entity through which the trustee may or must invest fund assets, the entire provision is void which would require the trustee to rely on the relevant State-based trustee legislation regarding authorised investments. It should only be if a provision *compels* a trustee to use a particular provider, entity or financial product, that the provision is void *to that extent*.

Further, the Committee submits that it should be acceptable for a particular provider, entity or product to be named in the governing rules as an option for the trustee to consider among the potential universe of particular providers, entities or products so long as the trustee is not compelled to use that named provider, entity or product. That is, even if a related service provider is named in the deed as a provider with whom the trustee *may* outsource business activities, the trustee should not be precluded outright from using that service provider. It may be that the trustee has decided that it would be in members' best interests to use that service provider, and there should be no trust law or prudential concern about that engagement

assuming the provider is engaged in accordance with the usual arrangements the trustee would follow for any other arm's length provider.

Accordingly, *the Committee submits that the notion of entire voiding should be replaced with the offending trust deed provision being void "to the extent that…" and also the Committee submits that the "may or" should be deleted where it occurs (4 times).*

Alternatively, the notion of voiding could be replaced with a legislative authority to the effect that a trustee is not required to comply with a provision to the extent that it requires the trustee to use a particular service provider or investment entity or purchase a particular financial product.

b) **Custodians:** The Committee notes that if a fund's assets are invested through a custodian (ie, the custodian holds the fund's assets custodially as is presently required by licensing conditions for all public offer superannuation funds), that arrangement does not constitute an investment *in* the custodian entity to which the proposed section 58A(3) could be relevant. If it were otherwise, an obligation in a fund's trust deed to ensure that the fund's assets be held by "a custodian" might be void because that would be the specification of an "entity", even though not named.

However, section 58A(2) regarding service providers could be relevant to a trust deed provision which states that the fund's assets must be held by "a custodian". If the custodian is named the section will make the provision void. The Committee appreciates that this is the intention of the provision. However, the Committee is concerned that the scope of the words "specifies a person" may be too broad. In particular, the provision could apply where a *title* or a *type* of service provider is specified, for example a provision which provides that the assets of the fund must be held by "a custodian" could be interpreted as a provision which specifies a service provider. Further, the Committee notes that lawyers for custodians and fund managers often ask for warranties or the like to the effect that the trustee has an express power to appoint them to provide services, so it would be problematic if trust deeds could not refer to *titles* or *types* of service providers a trustee is to use.

The Committee therefore suggests that the words "specifies a person" in sections 58A(2) and 58A(3) should be replaced with the words "names a person".

3.2 Chapter 2: Infringement notices

The Committee understands that as a matter of policy it has been decided that APRA is to be given the power to issue infringement notices. However, the Committee has some concerns about whether the regime as set out in the Bill is too broad and has too few limitations.

a) **Infringement notice - enhanced content for notice:** Under the proposed provisions, all that is required in order for an infringement notice to be issued is that an APRA infringement officer has "reasonable grounds" for believing that a provision that is subject to an infringement notice has been breached (proposed section 224(1)). The contents of the infringement notice do not have to contain many details about the alleged breach. The Committee has two submissions to make in this regard:

- *The Committee submits that details regarding the "reasonable grounds" for the officer's belief should be set out in the infringement notice*. Otherwise, in some cases the Committee would be concerned that it may be too easy for an infringement officer to issue the infringement notice if there is no requirement to provide details about the "reasonable grounds" leading to the belief that a provision has been contravened. Even aside from that, if the recipient of the notice does not receive information about the "reasonable grounds", the person could be left entirely in the dark about what led to issuance of the notice which would prejudice the person's ability to challenge (or decide to challenge) the notice.

- Similarly, *the Committee submits that details regarding the circumstances of the alleged breach should be set out in the infringement notice with a high level of specificity* (ie, more than just the time, date and alleged place of the contravention as is currently specified in proposed section 224A(1)(e)(iii) which of course would be suitable for a motor vehicle offence but insufficient the Committee would think for many cases of alleged breaches in relation to the often complex web of compliance obligations applying to large superannuation funds).

b) **Regulations may provide additional provisions to be subject to infringement notice:** As set out in the EM and by way of particular provisions being specified in proposed section 223A, the Committee understands that the provisions which may be subject to an infringement notice, if breached, amount to "minor and straightforward" matters. However, proposed section 223A(3) provides in effect that the regulations may provide that an offence against *any* provision of the Act or *any* regulation is subject to an infringement notice. However, there is no limitation as to the scope of those provisions. Given the purpose of the infringement notice regime and the intended ease with which infringement notices can be issued, the Committee is concerned to ensure that some limitation be placed upon the other provisions which may become subject to an infringement notice by way of regulation. Otherwise, at its most extreme, potentially every single regulation and every section of the Act could be made subject to the infringement notice regime, despite the modest and confined list of initial provisions set out in sections 223A(1) and (2).

Accordingly, *the Committee submits that section 223A(3) should be amended to provide some limitation of scope as to the type of provisions in the Act and regulations which may be subject to an infringement notice*. *For example, civil penalty provisions might be excluded.*

c) **Exemption from liability:** Under section 224D(1)(a) a trustee who pays the amount in a penalty notice will be discharged from “any liability .. for the alleged contravention”. The Committee has two comments in relation to this section.

First, the Committee notes that the section would apply in relation to a claim brought by a beneficiary of the fund in relation to some misconduct of the trustee. It is not clear to the Committee that it is a desirable or an appropriate outcome of the infringement notice provisions to have a complete discharge from "any liability" and the Committee queries whether

the discharge from liability is intended to extend to civil actions brought by beneficiaries or other third parties. If this is the case, it should be stated in the EM.

Second, the Committee considers that section 224D should be amended to expressly provide that if a trustee pays the amount in a penalty notice:

- no further action can be taken by a regulator in relation to the ***conduct*** which is the subject matter of the penalty notice. Currently the exemption applies only in relation to the alleged contravention of the particular provision – the same conduct could amount to a contravention of more than one provision or to a general law action; and
- the fact of payment cannot be used in any other proceeding or matter (including in the Superannuation Complaints Tribunal) against the trustee relating, again, to the relevant conduct rather than to the "alleged offence" (see paragraph (f)).

d) **Indemnity for payment of amount under infringement notice:** Under sections 56(2) and 57(2) a trustee (or director) who pays an amount under an infringement notice will not be able to be indemnified from the assets of the fund for the amount of the penalty. The Committee is concerned that the limitation of the trustee's right of indemnity may raise a conflict of interest for a trustee and may in fact not serve the interests of fund members. More often than not it will be in the interests of fund members for the trustee to pay the amount in an infringement notice rather than incur the costs of defending an action by APRA. It is not clear why a trustee, should have to assume the burden of paying the amount where it is clearly in the interests of fund members to do so, particularly where the trustee has not acted dishonestly or recklessly or even in breach of the relevant provision. Further, in many cases a trustee will not have the internal resources to pay an infringement notice. In this case, the trustee would be forced to incur the costs in defending an action against it.

The EM says that: "*one of the reasons the Review recommended providing APRA with the ability to issue infringement notices is to deter uncompliant behaviour. This objective would be undermined if trustees and directors were able to use fund money to pay for the infringement notice.*" An infringement notice may be given where the infringement officer has reasonable grounds to believe there is a contravention. There may well not be a contravention. In this case, it appears to be particularly punitive to require the trustee to pay the amount in an infringement notice from its own resources (if, indeed, it has any).

Separately, the Committee notes that items 70 and 71 both appear to insert the same provisions into the SIS Act and queries whether this is an error.

3.3 Chapter 3: Reasons for decisions and SCT time limits

a) **Process for the giving of reasons following a request:** Proposed sections 101(1)(c) and 101(1)(d) of the SIS Act allow a person to require a trustee to provide written reasons in relation to a complaint. However, while section 101(1)(e) requires a trustee to respond within 28 days in the ordinary course, neither section 101(1)(c) or (d) imposes any time limit on the complainant's ability to request written reasons.

Therefore, a trustee could potentially have to stand ready indefinitely so as to respond (in a short time frame) to a request for reasons. The trustee's ability to properly respond to a request for reasons will naturally decline as the months and years elapse. Accordingly, *the Committee submits that a time limit should be imposed in proposed section 101(1)(d) for the making of the request for reasons.* The time period should commence once the decision has been communicated (rather than once it has been made, as there may be a time delay between the two events). Ninety days would seem to be an appropriate time period, particularly given the 90 day time limit set out in section 101(1)(c)(ii). The decision by an applicant to request reasons should not be something which requires detailed consideration or legal advice, and their interest in pursuing reasons should be most heightened shortly after receiving information about the trustee's decision on the complaint.

The Committee makes no comments on the amendments in relation to the SCT time periods.

3.4 Chapter 4: Dual regulated entities

The Committee makes no comments on the amendments covered by this chapter.

3.5 Chapter 5: Actions for breaches of directors' duties

a) **Good faith of the singular applicant:** The Committee notes that the test in proposed sections 29VPA(4) and 55(4B) is that the court must take into account whether "the applicant" is acting in good faith. *The Committee submits that the possibility of there being representative (class) actions should be contemplated when referring to the "the applicant"* - ie, does it have to be demonstrated only that the single representative applicant is acting in good faith or could there be some requirement to take into account the bona fides of the whole class? The Committee acknowledges that there may be some court rules or perhaps other legislation which deals with this issue, but in any event the Committee thought it would raise the issue in case there are any drafting changes which could or should be made now so as to avoid future problems.

b) **Serious question to be tried:** The Committee notes that proposed sections 29VPA(4) and 55(4B) require that the court consider whether there is a "serious question to be tried", and that this is properly a more onerous threshold than a test based on whether the application is frivolous/vexatious or an abuse of process etc. However, the Committee believes that because of the status of the case law in relation to other contexts in which the test is used[1], there may be some ambiguity about whether the applicant would need to show a "sufficient likelihood of success to justify in the circumstances [the action]" (*ABC v O'Neill* (2006) 227 CLR 57). This is because it is unclear whether the need to show a "sufficient likelihood of success" is as a consequence of the "serious question to be tried" requirement or the "prima facie case" requirement. The Committee believes that, in order to effectively prevent unmeritorious claims (and thereby protect directors[2] from unnecessary and costly litigious

[1] It is the test used by a court granting interlocutory relief pending a trial on whether to grant final relief, and the test for leave to bring a "statutory derivative action" under section 237 of the *Corporations Act 2001*.
[2] And potentially funds, where the director has an indemnity

processes) claims should not be allowed to be brought if they are not sufficiently likely to succeed.

Accordingly, *the Committee submits that the section should be amended to make it clear that a higher threshold than what is ordinarily required in order to bring proceedings in a court must be made out by the applicant in order for leave to be granted. It should also be amended to make it clear that a court may also take into account other matters if it considers it relevant to do so*.

c) **Section 55(5) defence of no practical use:** The Committee notes that the drafting of section 55(5) as recently passed in the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012 will be further amended by replacing the words “in relation to the investment” with “in relation to each act, or failure to act, that resulted in loss or damage”. This amendment does not address the significant issues associated with section 55(5) and which were addressed in our submission to Treasury on the exposure draft of the fourth tranche. In that submission we said that the effect of section 55(5) was that, in order to have a defence to an action for loss or damage suffered by a person as a result of the making of an investment within the fund, the trustee or director will have to establish that it complied with each and every one of the covenants in sections 52 to 53 and prescribed in section 54A, and all of the enhanced MySuper obligations referred to in sections 29VN and 29VO that apply to the defendant in relation to the investment. Because of the broadly-stated nature of many of the covenants and obligations, and because of the positive obligation to "establish" compliance, the Committee believes that it will be practically impossible for this defence to be used. The evidence involved in establishing positive compliance with so many obligations would be extremely onerous. Indeed, if a trustee or director were able to demonstrate compliance with every such covenant and obligation, the action would necessarily fail and the defence would not even be needed. In other words, the effect of the revised drafting is to provide a defence only where the trustee or director can show that they had done nothing wrong in the first place.

The Committee also notes that the practical operation of the changed provision will potentially affect past investment decisions (eg, an investment in an unlisted asset which is still held and which can be negatively revalued at any point). Further the Committee notes that it cannot be assumed that professional indemnity policies will respond to claims relating to investment decisions because most policies usually specifically exclude such matters.

Section 55(5) as it first appeared in the SIS Act in 1993 was a defence available to a trustee having regard to "modern portfolio theory" – ie, that if a trustee properly chose a diversified portfolio of investments it would be protected if, for example, one of those investments performed badly when, in the context of the whole portfolio, the trustee had properly formulated and implemented an investment strategy. Now, the revised version of section 55(5) turns the original purpose of the defence and protection for trustees on its head, and renders it effectively useless. Therefore, if a member alleges that one of the trustee's investments performed poorly and resulted in a negative interest adjustment to the member's account, the member could seek to take action against the trustee company and/or (with the leave of the court) the directors to claim the loss and the trustee/

directors would be put to the task of proving positive compliance with *every* covenant and obligation related to the making of the investment before it would have a statutory defence.

Accordingly, *the Committee submits that a provision should be added to the Bill to amend section 55(5) so that it reverts to providing a meaningful "safe harbour" for directors and trustees who have acted in accordance with the entity's investment strategy*.

There are similar concerns in relation to section 55(6) regarding the defence in relation to the management of reserves, and so *the Committee submits that a similar provision should be added to the Bill to amend section 55(6) also*.

A suggestion for the drafting is as follows:

"55(5) It is a defence to an action for loss or damage suffered by a person as a result of the making of an investment by or on behalf of a trustee of a superannuation entity if the defendant establishes that the investment was made in accordance with an investment strategy formulated under a covenant referred to in section 52(6), unless it is established that the defendant has relevantly breached one or more of the covenants referred to in sections 52 to 53 or prescribed under section 54A, or has relevantly breached one or more of the obligations referred to in sections 29VN or 29VO, that apply to the defendant in relation to each act, or failure to act, that resulted in loss or damage."

3.6 Chapter 6: Other measures and consequential amendments

The Committee makes no comments on the amendments covered by this chapter, other than the amendment to section 29WA(1)(c) as noted below.

a) **Acknowledgement of change of principle:** The proposed amendment to section 29WA(1)(c) superficially makes a very minor wording change from "choice product" to "specified investment option". The EM explains that this amendment is intended to clarify that a member must make a direction to have contributions placed in a particular investment option, and it is not sufficient that the member has joined the fund by a process of choice. In the Committee's view, this is a fundamental change from the principles enunciated in the June 2011 "Super System Review Final Report" (Cooper Report) regarding the disengaged members who were designed to be protected by the MySuper arrangements, and also a fundamental change from the statement of the government's response set out in the September 2011 "Stronger Super Information Pack" (Government Response). For example, in section 2.2 of the Government Response it is stated that: "From 1 October 2013, employers must make contributions for employees who have not made a *choice of fund* to a fund that offers a MySuper product in order to satisfy superannuation guarantee requirements" (emphasis added).

Just as in other places the amendments proposed in the Bill are referenced to recommendations of the Cooper Report, *the Committee submits that the deviation from the Cooper Report and the Government's Response should be noted in the EM in relation to the change to section 29WA(1)(c) so as to*

avoid future ambiguity and confusion. This is particularly important for those who have already designed their MySuper product offering based on the previous wording.

b) **Effect for funds not offering investment choice:** Assuming that the change to section 29WA(1)(c) is intended notwithstanding the change from the original design, the Committee is concerned that the implication of this change for superannuation funds which presently do not offer investment choice will be significant. That is, for funds which have one investment strategy that is set by the trustee, even if every member of that fund makes a positive choice to be in that fund, the trustee will be compelled to apply for a MySuper authorisation in order to continue to receive any contributions. *The Committee submits that some acknowledgement of this implication for funds of this type be made in the Bill (or, if not, at least clarified in the EM)* - ie, that such funds will be forced to close by 2017 because they do not offer investment choice unless their fund is restructured.

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 60,000 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 2013 Executive are:

- Mr Joe Catanzariti, President
- Mr Michael Colbran QC, President-Elect
- Mr Duncan McConnel, Treasurer
- Ms Fiona McLeod SC, Executive Member
- Mr Justin Dowd, Executive Member
- Ms Leanne Topfer, Executive Member

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