Inquiry into the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) 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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1 About the Law Council of Australia, Superannuation Committee

1.1 The Law Council of Australia is the peak national representative body of the Australian legal profession, and represents some 56,000 legal practitioners nationwide. This submission has been prepared by the Law Council of Australia's Superannuation Committee, which 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 makes submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

2 Outline of submission

2.1 The Committee has set out its key concerns in the body of this submission. The Attachment sets out technical issues arising from the proposed requirements for performance-based fees and the disclosure of underlying portfolio holdings.

2.2 The Bill contains 7 schedules. The Committee's comments on the Bill are organised in the same order as the schedules to the Bill.

2.3 As a preliminary matter, the Committee queries whether 1 July 2013 is a realistic start date for these reforms, particularly given the absence of regulations and regulator guidance that is still outstanding. In this regard, the Committee notes the extension to 1 January 2014 for certain employer obligations.

3 Schedule 1 - Fees and costs

MySuper members must not bear costs associated with conflicted remuneration

3.1 The Committee has a number of concerns about proposed section 29SAC(1) of the Superannuation Industry (Supervision) Act 1993 (SIS Act). This provision sets out the conditions which a trustee must satisfy in order to make an election as part of their MySuper authorisation application. If a trustee makes the election (as they will be required to do to receive their MySuper authorisation) they will undertake not to charge MySuper members a fee which directly or indirectly relates to costs incurred by the trustee in paying conflicted remuneration to a financial services licensee or to a representative of a financial services licensee *or to another person who will in turn pay conflicted remuneration* to a financial services licensee or to a representative of a financial services licensee: see proposed section 29SAC(1)(a)(i) and (ii).

3.2 The Committee considers that the election process is inappropriate. It also considers that the provision will detrimentally affect trustees where they have continuing obligations to pay conflicted remuneration under grandfathered arrangements.

Elections and paragraph 51(xxxi) of the Constitution

3.3 The Committee is also concerned about the effective requirement for trustees to “elect” to do certain things – in this case, to not charge fees relating to paying conflicted remuneration, but also in proposed section 29E(6A) of the SIS Act to transfer accrued default amounts. The Committee thinks that this approach is an attempt by the Government to avoid the question of whether a particular provision could breach paragraph 51(xxxi) of the Constitution. If a trustee elects to give up their property, it might be said that there has not been an acquisition of that property. The Committee members are not Constitutional law experts. However, the members do note that the question of whether there has been a breach of this prohibition is a question of substance not form; your attention is drawn to a statement made by the majority in the High Court in *Georgiadis v Australian and Overseas Telecommunications Corporation* (179 CLR at 305) that - “It is often said in relation to constitutional guarantees and prohibitions that ‘you cannot do indirectly what you are forbidden to do directly’”.

3.4 The Committee notes that if a trustee does not make the elections in respect of fees and accrued default amounts in its MySuper application, it will not receive a MySuper authorisation. For most trustees this would result in a significant loss of business and possibly the closure of their business. As such the Committee observes that the opportunity afforded by the Bill for trustees to elect whether to do something or not is a false opportunity. The Committee considers that it is the Government’s responsibility to take legal advice about whether paragraph 51(xxxi) applies to a particular provision of this Bill or not. Following that advice, it should form a view. If it forms the view that it does apply, the legislation should not ask trustees to elect to do something which the Government could not require them to do; if it forms the view that it does not apply, then it should require trustees to do that thing by means of a direct obligation.

Ongoing obligation to pay conflicted remuneration

3.5 The provision is not subject to the same grandfathering provisions as those in the Future of Financial Advice reforms. The consequence is that a trustee may be required to pay conflicted remuneration under a grandfathered arrangement after the commencement date of the Future of Financial Advice reforms and the Stronger Super legislation, but will be unable to deduct that payment from a member’s account if they are a MySuper member. The Committee considers that section 29SAC(1)(a) should be subject to the same grandfathering arrangements as apply under the Corporations Act.

Performance-based fees

3.6 The proposed requirements in relation to performance-based fees have been drafted in simplistic and aspirational terms which, in practice, are likely to be problematic and ambiguous in several respects. As such, there would be potential for considerable uncertainty as to whether or not particular arrangements comply with the proposed requirements. For RSE licensees who are unwilling to bear that compliance risk (i.e. who are unwilling to bear the burden of satisfying the regulator that they qualify for the exemption), the proposed requirements may discourage the use of performance-based fees altogether. This could result in inferior outcomes for members because the consequence, at least in some cases, may be that RSE licensees err on the side of base fees which, in the case of underperforming managers, would be higher than the fees which would have been payable if a performance-based fee arrangement were in place.

3.7 Numerous technical issues are outlined in the Attachment in relation to particular requirements, for example, the requirements to calculate performance-based fees after-tax and with regard to the performance of other investments of a similar kind, and the inflexible requirement to calculate performance on an after-fee basis (even where an appropriate hurdle return has been surpassed).

3.8 In the Committee's view, RSE licensees should be encouraged to calculate performance-based fees outside the legislation, given the difficulties and the range of different approaches which could legitimately be taken. However, if there is to be a legislative requirement, the requirement should be one that is sensible and capable of being complied with. The Committee would recommend a more dynamic formulation of the requirement. For example, when calculating performance-based fees, RSE licensees might instead be required to use their reasonable endeavours to estimate performance after making adjustments on account of Australian taxes to the extent considered reasonable and practicable, on the basis of such assumptions which the RSE licensee considers to be reasonable in all of the circumstances. Otherwise, RSE licensees may be driven away from utilising performance-based fees altogether.

Operating standards

3.9 The Committee notes that new section 33A allows operating standards to be made that elaborate, supplement or otherwise deal with any aspect of a matter to which a covenant relates. The covenants are broadly intended to entrench traditional trustee duties. It therefore seems incongruous for subordinate legislation (such as operating standards) to affect the interpretation and application of equitable duties. It is another matter if separate operating standards are introduced dealing with the *subject matter* of a covenant, as opposed to a standard that might affect the *interpretation* of a covenant. For example, this is currently the case with the investment strategy covenant under section 52(2)(f) and the investment strategy operating standard that separately applies under regulation 4.09.

Change to MySuper fee rules

3.10 Item 26 of the Bill amends the definition of 'investment fee' inserted by the MySuper Core Provisions Bill under proposed section 29V(3). As a result of the amendment, it will no longer be possible for trustees to recover costs incurred by the trustee (that are not otherwise charged by way of another fee). This is because, under the new definition, investment fees must relate to the investment of the fund's assets (whereas previously the investment fee was an inclusive amount). This may mean that there is no longer a permitted fee that can include costs incurred in respect of MySuper members that would fall within a trustee's general right of reimbursement under trust law.

3.11 An example would be if a trustee were to incur legal costs in properly defending a benefit claim by an individual MySuper member, say a claim for a TPD benefit that had been properly refused by the insurer. These costs would ordinarily be able to be indemnified out of the fund (to the extent that the trustee did not elect to recover them under an indemnity insurance policy). It is difficult to categorise such costs as related to the administration and operation of the fund or to the investment of the fund assets. Further, those costs would not appear to fall within the definition of an 'activity fee' under proposed section 29V(7), because an activity fee is defined as a fee that relates to the costs incurred by the trustee that are directly related to an activity engaged in at the request or with the consent of a member or that relates to a member and is required by law.

3.12 The Committee therefore considers that either the administration fee or the investment fee should be an inclusive fee rather than a restrictive fee. Otherwise choice members may end up subsidising costs incurred in respect of MySuper members that do not fall within one of the permitted fees.

General fee rules

3.13 The Committee notes that the general fee rules apply to all regulated superannuation funds (other than self-managed funds) and across both choice and MySuper products. They will prohibit entry fees, require certain fees to be charged on a cost recovery basis and restrict the way the cost of advice is charged.

3.14 The proposed definition of "switching fee" (see proposed section 29V(5)):

(a) overlaps with the concept of buy/sell spreads (since buy/sell spreads are also designed to capture the costs of deploying/liquidating the cash flow associated with switching activity);

(b) only captures switches between classes of beneficial interest, but does not capture (and therefore does not limit) fees which may be charged for switching between investment options within the same class.

The Committee suggests that this definition should instead refer to costs (other than transaction costs recovered through a buy/sell spread) related to a change in the investment of a member's interest in a superannuation entity.

Allocation of costs

3.15 The Committee notes that section 99E will introduce a statutory obligation for trustees to ensure that costs are attributed between different classes of beneficiaries 'fairly and reasonably'. This obligation differs from the equitable obligation (and proposed new covenant) to treat different classes of beneficiaries fairly by introducing a 'reasonableness' component. (The Explanatory Memorandum does not provide any explanation for this difference.)

Cost of financial product advice

3.16 Proposed section 99F will prohibit the cost of particular kinds of personal advice (ie advice that is not broadly 'intra fund advice') being charged to members of the fund as a whole and requires the cost of that advice to be met by the member to whom the advice is given.

3.17 Proposed section 99F(1)(c)(ii) would protect the general membership from the cost of advice which has been given to a particular member that relates to a "financial product that is not a beneficial interest in the fund". The Committee remains concerned that this would be very difficult to administer where a fund offers members a limited range of "investment options" some of which may be financial products in their own right, because the trustee would need to track which advice relates to which investment option. In the Committee's view this provision should apply only where the fund is in the nature of a "super wrap" (where all or the great majority of the available investment options are financial products in their own right).

3.18 Many investment options within a superannuation fund are generally not regarded as financial products in their own right. As such, the legislation would not prevent a trustee from charging the general membership for the costs of advice provided to members to assist them in choosing between investment options offered within the fund.

3.19 However, in other cases, investment options may constitute a financial product. This is commonly the case where a trustee offers ethical investment options and chooses to do so by offering investment in an ethical fund that is itself a financial product. Also, how does the provision apply when all investments are made through an interposed vehicle such as an investment policy (again where the investment policy is itself a life insurance product)?

3.20 The Explanatory Memorandum (at para 1.48) suggests that the reason for this prohibition is to exclude advice in relation to a regulated acquisition as defined in section 1012IA under the Corporations Act. However, the breadth of section 1012IA has the potential to operate incongruously where

only one investment option of a fund is a financial product and must be excluded from intra fund advice.

3.21 There is also a difficulty with the drafting of proposed section 99F(1)(c)(iv), which refers to the reasonable expectations of the 'subject member' about whether the adviser will periodically review the advice, provide further personal advice or monitor the implementation of the recommendations in the advice (or in any later advice). In the Committee's view, the trustee should not be required to form a view about a member's reasonable expectations in order to determine whether the cost of that advice can be borne by the general membership. The Committee suggests a more principled approach such as: where personal advice relates to a specific member's interest in the fund, the cost of the advice must be borne by the specific member except in the following instances. The legislation could then list the matters that would generally fall within the concept of 'intra fund advice'.

4 Schedule 2 – Provision of benefits

4.1 New section 68AA would require trustees to "ensure" that their fund "provides" death and permanent incapacity benefits and that these benefits are "provided by taking out insurance". It is unclear from the drafting whether a trustee would be in breach of these obligations if, through no fault of the trustee, the insurer failed to honour the insurance policy (e.g. in the event of insolvency or other default). A trustee ought not to be in breach of the legislation in such circumstances and this would ideally be clarified in the drafting, perhaps by insertion of a provision deeming the trustee to comply if the trustee has an insurance policy for these benefits.

4.2 These provisions also appear to apply to existing members of the fund. Trustees who negotiate insurance cover for existing members (and new members) should be protected from liability in the event that a member complains about the cost of the insurance cover or any detrimental impact taking out that cover has on the member's existing cover. The Committee notes for example that many policies provide for the sum insured to be reduced by cover provided under another policy held for the person.

5 Schedule 3 – Collection and disclosure of information

Product dashboard

5.1 Proposed section 1017BA(2) requires a trustee to publish a product dashboard for each MySuper product and each investment option offered by a Choice Product.

5.2 The proposed sections 1017BA(1) and (2) would require product dashboards to include details of "the average amount of fees and other costs …. expressed as a percentage of the assets" of the relevant MySuper product or choice product. There are several difficulties and potential ambiguities arising from this drafting.

(a) Some kinds of fees are typically specified in dollar terms. It is therefore difficult to express a single all-encompassing figure in percentage terms, unless assumptions are made about the size of members' accounts. To address this, the legislation could either allow fees to be disclosed:

    (i) as a combination of dollar-based fees and percentage-based fees (in which case dashboards would essentially be the same as the standard fee template which is already required to be included in Product Disclosure Statements); or

    (ii) as a percentage figure with reference to a hypothetical member with an assumed account balance, so that dollar-based fees can be converted into a percentage (in which case dashboards would essentially be the same as the mandatory worked-example which must already be included in Product Disclosure Statements).

(b) Product Disclosure Statements already include details of the Indirect Cost Ratio, which is a historical figure reflecting total management costs (other than account based fees) in percentage terms, for the most recently completed financial year. The new information which would be required to be included in the product dashboard could be significantly different from the published Indirect Cost Ratio and other fee information in the Product Disclosure Statement, which could cause confusion amongst members. For the reasons outlined below, the information in the Product Disclosure Statement should in most instances be the most accurate estimate of what the annual fees and charges are likely to be, so the usefulness of creating a new, less-meaningful measure of fees and charges (for inclusion in the dashboard) is questionable.

    (i) The new requirements seem to focus on fees and charges incurred in a quarter. This could create confusion, because percentage-based fees are usually expressed on a per annum basis, rather than on a quarterly-basis. If the intention is for product dashboards to be updated quarterly with annualised figures, this should be made clear.

    (ii) It is unclear whether the new requirements are intended to focus on "actual" fees and charges or on "estimated / accrued" fees and charges. If the intention is for "actual" fees and charges to be disclosed, then the 14 day period is likely to be insufficient for most trustees. This is because trustees must necessarily wait to receive, for example, invoices from their external managers for investment management fees and quarterly reports from the pooled vehicles in which they have invested in order to know what the actual fees and charges for the period were. On the other hand, if the intention is for estimated accrued fees and charges to be disclosed, then the Indirect Cost Ratio (which is already required to be disclosed

in the Product Disclosure Statement) will in many instances be the best estimate of the likely fees and charges over the course of a year, in which case the proposed dashboard requirements are not improving the level of disclosure.

(iii) In addition, it is important to understand that performance-based fees typically only become payable at the end of the financial year. As such, if dashboards are intended to focus on quarterly fees and charges, there is potential for there to be a significant discontinuity in the published data once the dashboard is updated at the end of the last quarter in the financial year (i.e. because the last quarter will include performance-based fees, whereas the earlier quarters will not include performance-based fees and will therefore be substantially lower).

(iv) In practice, most funds will accrue fees and charges during the course of a year on a best estimate basis. If dashboards are intended to focus on actual fees and charges, then there will be a mismatch between what is disclosed and what the member has actually borne. If the dashboards are intended to focus on estimated accrued fees and charges (so as to align with what the member has borne), then the Indirect Cost Ratio is likely to be the basis of that estimate, meaning that the dashboard requirements would not really improve the quality of disclosure.

5.3 In the case of 'super-wraps' that offer a large range of investment options which are financial products in their own right and typically provided by third party fund managers, it is likely that trustees will be heavily reliant upon those third parties to provide the dashboard data or actually to prepare the dashboard. The defences which protect trustees who take reasonable steps to ensure that their dashboards are up-to-date and not misleading or deceptive should be broadened so as to clarify that those defences will be available in cases where trustees reasonably rely upon third parties in connection with the preparation of dashboards. For example, beyond making due diligence enquiries, a trustee is entirely dependent upon a third party fund manager to have correctly calculated their historical performance and therefore in ascertaining how many times the performance objective has been achieved.

5.4 It is also unclear how the product dashboard will apply to 'legacy products'. The Committee suggests that, due to the difficulties in obtaining the dashboard data for these products, consideration should be given to exempting them from this requirement, particularly since they cannot be actively 'selected'.

Obligation to publish information about underlying holdings

5.5 The Committee is particularly concerned about the complexity and uncertainty of the drafting of proposed section 1017BB of the Corporations

Act and the difficulty for trustees in trying to comply with it. The term "assets derived from assets" is very unclear. A lack of clarity in the provision will cause real difficulties for trustees in trying to comply with it.

5.6 The Committee notes that the provision seeks to introduce a fairly simple concept – the disclosure of funds' portfolio holdings, but considers that there would be numerous legal and practical difficulties in complying with the obligation in its current form. There are also risks for trustees. They include:

(a) the potential for the holdings data to constitute an endorsement of the securities held, and therefore financial product advice, possibly in breach of licensing requirements;

(b) breaching contractual restrictions imposed by existing data licensing agreements which have been entered into with benchmark manufacturers (such as MSCI, Standard & Poor's and FTSE) which would prevent assets held by passively managed options being disclosed if this would reveal the composition of the relevant benchmark;

(c) problems with trying to obtain information from third parties;

(d) a lack of clarity in knowing how many levels of investments they need to disclose;

(e) the potential to mislead members by disclosing multiple, overlapping layers of investments and possible 'double-counting'; and

(f) significant issues of valuation due to the effect of currency hedging and derivative exposures.

5.7 Some investment options offered by large superannuation funds could have exposure to more than 15,000 securities and the Committee queries whether it would be more useful to disclose:

(a) only the top 20 or top 50 holdings; and

(b) the percentage of the relevant option's assets which has been invested in those securities (rather than the number of shares and price per share).

This would be a sensible exercise of the power to prescribe a materiality threshold, as contemplated by the proposed section 1017BB(4).

5.8 Various difficulties and risks are outlined in detail in the Attachment.

Regulations may require public disclosure of actuarial reports

5.9 The Explanatory Memorandum (at 3.57) foreshadows that regulations will require actuarial reports for defined benefit funds to be published on fund websites. The Committee queries whether it is necessary for actuarial

reports to be published on public websites or whether it is sufficient for the reports to be made available to members on a part of the website which can be accessed only by members.

Providing information to a trustee

5.10 Proposed section 13(4A) of the Financial Sector (Collection of Data) Act 2001 provides for standards to be made to require an RSE licensee to provide information about a fund's investment of assets or assets derived from assets. The standard will require the provision of information about the investment of assets by a person "connected" to the licensee. To enable the RSE licensee to obtain the information, contracts or arrangements between the RSE licensee, a related body corporate of the RSE licensee or a custodian and a person connected with the trustee are taken to include certain terms. They include that the person connected to the RSE licensee must provide the RSE licensee, its related body corporate or custodian with the prescribed information. The Committee queries the effectiveness of this provision. What if the counterparty to contract or arrangement is a non-resident? If the provision is ineffective, a trustee may well be unable to obtain the information prescribed by the standards. In the Committee's opinion, the duties imposed by these provisions on trustees should be expressed as duties to take reasonable steps to provide the prescribed information. While the provisions do provide for a reasonable steps defence, trustees should not be forced to defend a failure to comply with a duty where they have, in this context, taken reasonable steps to do so.

Publication of remuneration

5.11 Proposed section 29QB(1)(a)(i) of the SIS Act will require publication of the remuneration of each director and other executive officer of the RSE. It is unclear whether this requires publication of information about remuneration paid by the RSE licensee or any remuneration received by the person, irrespective of its source. This should be made clear.

5.12 The Committee notes that this requirement would seem to go further than analogous Corporations Act requirements for disclosure of the remuneration of public company officers in 'bands'.

Quarterly reports published by APRA

5.13 Proposed section 348A of the SIS Act will require APRA to publish certain information about MySuper products. The obligation does not apply to the extent that its operation would result in an acquisition of property other than on just terms. The Committee considers that Government should take a view as to whether a particular provision of the law would breach paragraph 51(xxxi) of the Constitution or not. It should not leave it to trustees or any other person to form a view and then challenge, in this case, publication of material about its fund by APRA.

6 Schedule 6 – Moving accrued default amounts

6.1 These provisions require a trustee applying for a MySuper authorisation to "elect" to transfer accrued default amounts of members to a MySuper product in the same fund or in a different fund offered by the trustee. The Committee noted above in paragraphs 3.3 and 3.4 its concerns with requiring trustees to do something by asking them to elect to do so. Those comments apply equally to the way the Bill deals with accrued default amounts.

Definition of accrued default amount

6.2 Proposed section 20B of the SIS Act will provide that an amount is an "accrued default amount" if the investment option under which the underlying assets are invested is the default investment option. It is not clear why a member who has chosen the default option should be treated in the same way as a member who has not. The Committee also notes that this broader concept of an "accrued default amount" goes further than the original MySuper concept, which was based on the absence of active choice.

6.3 The Explanatory Memorandum states (at 6.12) that "the term therefore captures amounts where the member has explicitly or implicitly directed that the amount be invested in the default investment option for that member". The rationale is stated as that the member "may have decided to delegate responsibility for investment decisions to the trustee by choosing the default option". This analysis proceeds on a fundamental misconception. If a member has actively chosen the investment option that also happens to be the fund's default investment option, this does not necessarily mean that the member has 'delegated responsibility' to the trustee. It is more likely that the member desired that particular risk/return profile or had advice from a financial adviser to adopt that investment option as part of the member's retirement planning.

6.4 The Committee strongly recommends that members who have chosen a default option should be distinguished from members who have not made an investment choice. Members who have chosen the default option should not have their existing balance moved to a MySuper product without their consent. In doing so, they are may lose their existing insurance benefits and other benefits available to choice members but not to MySuper members.

6.5 If the Committee's recommendation is accepted, it would be a simple drafting change to remove paragraph (ii) from proposed section 20B(1)(b).

Attachment

1 Performance Fees

General comments

1.1 The proposed requirements in relation to performance-based fees have been drafted in terms which are too simplistic, ambiguous and aspirational and will likely be too difficult for RSE licensees to comply with. As such, the proposed requirements would pose a significant ongoing compliance risk and therefore they would potentially create a disincentive against using performance-based fees.

1.2 The Committee is aware of at least one large superannuation fund which has carefully considered the proposed requirements and formed a preliminary view that, going forward, it may cease utilising performance-based fees given the impracticalities of complying with the proposed requirements, rather than having to bear the burden and risk of proving that non-complying arrangements were nevertheless in the best interests of members. This would be an unfortunate example of legislative reforms driving inferior outcomes for members. The immediate consequence will be that underperforming asset managers will receive base fees which are higher and effectively guaranteed, compared to the fees they would receive under a performance-based remuneration arrangement.

1.3 The key concerns, all of which can be easily addressed by revising the proposed legislation, are as follows.

After-tax performance calculations

1.4 The most troubling of the proposals is the requirement that performance-based fees be calculated "where possible" on "an after-tax basis".

1.5 It is unusual for the drafting of legislation to impose a requirement to do something "where possible". This kind of drafting is aspirational and more suited to non-binding industry codes or regulatory guidance. The point is that (almost) anything is "possible", but the degree of cost and inconvenience which is involved in complying with the proposed obligation is a rather different matter.

1.6 The reference to calculating performance on an "after tax basis" is also ambiguous. While the concept is easy enough to understand in the abstract, it can mean different things in different contexts. While some superannuation funds and asset managers already attempt to take tax into account when estimating and publishing their returns, it is critical to understand that this will typically involve making assumptions about tax rates and often using particular figures as proxies for the true amount of tax. The proposed legislation does not explicitly allow scope for such liberties to be taken when estimating after-tax performance. The following examples illustrate the point.

(a) To calculate after-tax outperformance, this requires both the portfolio return and the benchmark return to be adjusted on account of tax. These are two separate tasks, both of which involve their own complexities.

(b) To calculate after-tax performance, it is not as simple as subtracting the standard 15% tax rate for superannuation funds from portfolio returns. (In many cases this will overstate the relevant tax and investment managers will be aware of this and seek to protect themselves through higher rates of fees.) A comprehensive after-tax calculation will require consideration to be given to the value of franking credits and adjusting for the impacts of tax-effective share buy-backs which may take place below market value (and which therefore appear to cause a portfolio loss, but which actually benefit the portfolio), income tax and capital gains tax. In Australia, long-term capital gains by superannuation funds are effectively only taxed at 10%, so assumptions must be made about the period of time for which assets were held.

(c) It is unclear from the proposed requirements whether RSE licensees would be required to take into capital gains tax only on realised capital gains or whether after-tax performance calculations would be required to accrue capital gains tax with regard to unrealised capital gains.

(d) It is also unclear whether the proposed requirements are intended to focus on actual tax borne by the fund or whether the focus is on some notional tax cost which might never be borne by the fund. For example, say that an RSE licensee appoints two investment managers, each with a starting portfolio value of $100 million. It is entirely conceivable that, over the course of the financial year, Manager 1 may grow its portfolio to $110 million (i.e. a gain of $10 million), but Manager 2's portfolio may fall in value to $90 million (i.e. a loss of $10 million). In this case (assuming the fund has no other assets), the fund's net income for the year is nil, meaning it pays no tax. It is unclear how the proposed legislation would require performance to be calculated on an after-tax basis in this scenario. Manager 1 may resist having its performance reduced on account of tax which was never in fact incurred by the RSE licensee; but if Manager 2 outperforms in the following year, Manager 2 may well argue that its returns in year 2 should not be reduced on account of tax because the fund should utilise the tax losses attributed to its performance in the prior year (assuming those tax losses had not already been utilised to offset the tax attributable to Manager 1's performance in the prior year).

(e) More broadly, it is unclear how tax losses from prior years would be required to be accounted for.

(f) Issues also arise in the context of calculating tax on long term capital gains. Manager 1 and Manager 2 might both have shares in ABC

Company in their respective portfolios. It is conceivable that Manager 1 may have had those shares in its portfolio for 2 years, but that Manager 2 may have only purchased those shares in the last month. If Manager 2 then goes on to sell those shares at a gain, a question arises as to how the performance-based fee calculations would need to be adjusted on account of capital gains tax. On the one hand, as far as the Australian Taxation Office is concerned, the RSE licensee would be entitled to say that it sold the shares which had been owned for longer than a year and that therefore only 10% tax is payable. However, by only adjusting performance by the amount of capital gains tax actually incurred, in this example, there is hardly a disincentive against Manager 2 'churning' its portfolio and crystallising tax-inefficient short-term capital gains. Further, not all funds would be equipped to conduct that kind of calculation or attribution. It is likely to be more practical (and more likely to encourage appropriate portfolio management behaviours) if a particular investment manager's performance is reduced on account of the capital gains tax which would be paid assuming that their portfolio represented the whole of the fund and therefore that all assets disposed of during the period were assets from their portfolio; but this involves estimating performance fees after-hypothetical-taxes, rather than after-actual-taxes, and it is unclear how this would sit within the proposed framework.

(g) These kinds of difficulties are even more manifest when calculating an after-tax benchmark return. A benchmark is an entirely hypothetical construct which does not actually exist and therefore does not file tax returns. Therefore estimating an after-tax benchmark return inherently involves making assumptions about what the tax position of the benchmark portfolio would have been if it were a taxpaying entity – for example, assumptions about the length of time for which assets were held and assumptions about whether or not the 'benchmark' participated in any share buy-backs during the year, and indeed assumptions about any tax losses which the benchmark would be able to carry forward from prior years (if it were a taxpayer).

(h) The above issues are difficult enough in respect of Australian taxes. However, the calculations would become impracticably complex if foreign withholding taxes are also expected to be taken into account. Portfolios might include exposure to a large number of jurisdictions globally. Those jurisdictions may indeed be different from the jurisdictions to which the benchmark contains an exposure. For example, the benchmark might include exposure to Afghanistan and Pakistan, but the RSE licensee might forbid the inclusion of securities from Afghanistan and Pakistan in its portfolios, even though those securities might be included in the benchmark. Depending on how the proposed legislation is intended to apply to foreign taxes, it potentially requires RSE licensees to have an understanding and to make calculations involving taxes in jurisdictions in which the RSE

licensee does not even invest (in order to calculate the after-tax benchmark return).

(i) Further, if foreign taxes are expected to be taken into account, presumably foreign tax credits (to avoid the imposition of double-tax within Australia) would also have to be taken into account, which adds further complexity and artificiality, especially as far as calculating an after-tax benchmark return is concerned.

1.7 The point to note is that calculating a true "after-tax" return difficult in practice, but theoretically possible. The proposed requirements would likely lead to RSE licensees having to pay additional fees, for example, to benchmark manufacturers, for the provision of "after-tax" benchmark returns in relation to every single benchmark that is used for the purposes of calculating a performance-based fee (and the large superannuation funds are likely to utilise many), thereby increasing costs to members.

1.8 In the Committee's view, RSE licensees should be encouraged to calculate performance-based fees outside of the legislation, given the difficulties and the range of different approaches which could legitimately be taken. However, if there is to be a legislative requirement, the requirement should be one that is sensible and capable of being complied with. The Committee would recommend a more dynamic formulation of the requirement. For example, when calculating performance-based fees, RSE licensees might instead be required to use their reasonable endeavours to estimate performance after making adjustments on account of Australian taxes to the extent considered reasonable and practicable, on the basis of such assumptions which the RSE licensee considers to be reasonable in all of the circumstances. Alternatively, RSE licensees may be driven away from utilising performance-based fees altogether.

Ambiguous application to modified (existing) arrangements

1.9 With regard to the treatment of existing performance-based fee arrangements, the Committee notes that the proposed requirements would only apply prospectively to arrangements entered into after the provisions take effect. It is important that this be the case, because it would potentially be quite contentious if RSE licensees had to renegotiate all of their existing performance-based fee arrangements, possibly in the middle of a performance period which would be quite sub-optimal. However, it is unclear whether the proposed requirements would start to apply if a modification were to be made to an existing performance-based fee arrangement: for example, an RSE licensee might agree to modify an existing performance-based fee by changing the hurdle return or by changing the benchmark. If this were to occur, it is unclear whether this would be regarded as 'entering into an arrangement' and whether this would therefore trigger a requirement to comply with all of the proposed requirements for performance-based fees. This should be clarified.

Application to pooled vehicles

1.10 The requirements relating to performance fees will only apply to arrangements with “investment managers”, which is a term with a defined meaning in the SIS Act. As such, the requirements would not apply to performance arrangements that apply in the following contexts:

(a) Investments in pooled funds, such as managed investment schemes and private equity funds; and

(b) Investment advisers and asset consultants who advise in connection with particular transactions or at an asset class level, but who fall outside the definition of ‘investment manager’ because they do not actually make discretionary buy/sell decisions in relation to assets held by the superannuation fund.

1.11 If the requirements were extended so as to apply to performance fees deducted from pooled funds, which might be justified on grounds of consistency, this would pose an even greater transitional burden on trustees, since the performance fees (which are ultimately borne by trustees) are set pursuant to arrangements between the pooled fund (e.g. the responsible entity of a managed investment scheme) and the relevant investment manager. Since trustees are not privy to those arrangements or negotiations, they would have no capacity to affect those negotiations or the basis on which performance fees are calculated.

Lower than alternative

1.12 Proposed section 29VC(3)provides that, if a fee in addition to a performance-based fee is payable to an investment manager, that other fee must be set or adjusted so that it is lower than it would be if the arrangement did not include a performance-based fee. The Committee submits that the drafting of this provision should also deal with the situation where an investment manager only ever conducts business on the basis of having management fees *and* performance-based fees. That is, in this case, it will be impossible for the manager to set the management fee at a lower level than it would otherwise be, because the arrangement always includes the performance-based fee. Perhaps in that case it goes without saying that the management fee would be higher if there were no performance-based fee (and therefore the converse is true whereby the management fee is lower because there is a performance-based fee), but that should be clarified.

After-fee calculations

1.13 The requirement that performance fees must be calculated on an after-fees basis ought to be more flexible, in order to accommodate arrangements which require a hurdle return to be achieved before performance fees become payable (i.e. to allow flexibility in cases where the hurdle return has been deliberately set with regard to the fact that performance fees are notionally calculated on a before-fees basis). It is a relatively common

compromise for trustees and investment managers to agree that performance fees can be calculated on a before-fees basis, provided that the hurdle return is increased by an amount corresponding to the rate of fees being charged. In dollar terms, this results in the performance fees being the same as they would have been, if the performance fees had been calculated on an after-fees basis (but with a lower hurdle).

1.14 The legislation should also clarify that performance fees only need to be calculated before-base fees. If performance fees have to be calculated after base fees and after performance fees, this gives rise to a mathematical circularity.

Choice of benchmark

1.15 The requirement that performance be measured by comparison with the performance of a similar kind should also allow for flexibility in certain cases.

1.16 For example, in the case of investment mandates relating to relatively unusual (or specific) asset classes, it is often considered appropriate to have regard to performance of the asset class in which the trustee would otherwise have invested. For example, if a trustee elects to divert funds away from listed equities to unlisted infrastructure, it would not be unusual for performance of the unlisted infrastructure investments to be assessed by comparison with the performance of a listed equities benchmark, even though these are different kinds of investments. Alternatively, it would also not be unusual for the performance of, say, an unlisted infrastructure portfolio to be measured against some other kind of benchmark, for example, a benchmark of CPI + x%. This might be justified on the basis that the cash flows of unlisted infrastructure assets are often linked to inflation and therefore the appropriate measure might be some hurdle rate of return in excess of inflation. Similarly, private equity managers are typically remunerated on the basis of outperformance over a fixed hurdle rate of return, rather than by comparison to performance of other private equity managers.

1.17 The proposed section 29VC(5) should therefore allow for comparisons to be made against "investments of a similar kind or a reasonable alternative to those investments or a reasonable proxy for adequate performance".

2 Disclosure of portfolio holdings

Disclosure should be on an option-by-option basis

2.1 The proposed legislation would appear to require holdings data to be disclosed on a whole-of-fund basis. This would render the data meaningless, largely irrelevant and potentially misleading from the point of view of members who would most typically only have an interest (if any) in the assets underpinning the investment options in which they have invested or in which they might choose to invest in future. Indeed, the proposed

requirement seems at odds with the product dashboard requirements which, for good reason, require the disclosure of tailored information on an option-by-option basis. The proposed legislation should be modified to address this and, consistent with the approach being taken with regard to other reforms, the initial focus could perhaps be on MySuper products with a longer transitional period for choice products.

Reliance on third parties for information

2.2 While the proposed section 1017BC would impose a requirement for relevant third parties to provide trustees with the information required to comply with the disclosure obligation under section 1017BB, that section is lacking in two critical respects.

(a) Firstly, there is no statutory deadline by which third parties must provide trustees with the information, which could defeat part of the purpose in allowing trustees 90 days after the end of each reporting period to publish the data (noting that the 90 days is presumably also intended to address any time-sensitivity attaching to commercial or proprietary data). If a trustee only receives the data after 89 days (or later), there would be little prospect of the 90 day reporting deadline being met by the trustee.

(b) Secondly, there is no obligation to provide the information in a format which is useful or convenient for the trustee. Given that large superannuation funds may have exposure to over 15,000 securities, it would be unhelpful if third party fund managers and so forth were to provide the necessary data in, say, hard copy format or in a PDF file (as opposed to say, an electronic spreadsheet in an agreed format), which would require the data to be manually re-keyed into the trustee's own portfolio systems. Given that some third parties may be opposed to the prospect of their pooled vehicles' holdings being disclosed, it is not inconceivable that some may provide data in an inconvenient format so as to comply with their statutory obligation while at the same time hindering the disclosure of that information to members.

2.3 The defences provided for by section 1021NB(5) and (6) would only apply where the trustee was unable to obtain the relevant information (amongst other things), but this would not cover situations where the information was obtained, but was obtained too late or in a format which was not reasonably able to aggregated with the trustee's other data within the required 90 day period.

2.4 For the above reasons, the obligations imposed on third parties by section 1017BC should be subject to a statutory deadline and data formatting requirement, and the defences provided by section 1012NB should extend to situations where the trustee received the data too late, having regard to the format of the data when it was received.

Model portfolios may constitute advice

2.5 There is a very real risk that members of the public will interpret holdings data as a recommendation of the various stocks which are listed in proportions which are similar to those invested by the relevant superannuation fund, and that at least some members of the public will partially replicate those holdings within their personal portfolios or within their self-managed superannuation fund. In other words, there is a real risk that the holdings data will be construed as financial product advice, in circumstances where it is not intended to be advice and where the person publishing the data (i.e. superannuation fund trustees) will often not be licensed to provide advice on securities, bonds, derivatives and other assets held by the superannuation fund. It appears that a policy decision has been made that this is desirable. That being the case, Chapter 7 of the Corporations Act should be clarified by way of an exemption or clear statement that the publication of holdings data will not constitute financial product advice (and/or the publication of that data is exempt from the requirements for an Australian financial services licence) and that trustees are not responsible for any losses resulting from reliance upon that data. To make the point, it is hard to imagine that any other person could carry on a business of publishing model portfolios on a periodic basis without requiring an Australian financial services licence.

Double-counting

2.6 Disclosing holdings on a look-through basis raises a serious issue of double-counting and meaningful disclosure. For example, the proposed section 1017BB requires disclosure of “each” of the financial products in which superannuation funds have invested <u>and</u> “each” of the financial products in which assets derived from the superannuation fund have been invested. For example, if a superannuation fund invests $10M into Managed Fund A, and Managed Fund A invests $10M into BHP Billiton, the proposed legislation would require disclosure of both the $10M worth of units in Managed Fund A, as well as the underlying exposure to $10M in BHP Billiton. This may lead members to suggest that there are $20M worth of assets in total, whereas this is not true, but rather a case of double counting (and there is obviously the chance of triple-counting or quadruple-counting depending on how many layers of vehicles there are). However, it would be dangerous to address the risk of double-counting by focussing only on the underlying holdings and not disclosing the interposed vehicles, because this would mislead members as to where the fund’s assets have been invested and the associated risks. For example, if a superannuation fund had invested $100M in Trio Capital which had in turn reported that it had invested the $100M into underlying assets, the proposed legislation could give rise to serious allegations by members that they had been misled if the interposed vehicle were to collapse (like Trio Capital) and members were unaware that they had any exposure to the collapsed vehicle as a result of the legislation focussing only on underlying holdings.

Problems concerning volume of data, range of asset classes, derivatives and foreign currency

2.7 The proposed legislation seems to focus mainly on investments in equities and managed funds that invest in equities. However, superannuation funds invest across various asset classes, including cash, fixed interest and property. For example, superannuation funds are increasingly investing in debt markets and are acquiring hybrid securities and other fixed interest securities. A question arises as to whether the look-through applies to debt securities, for example, securitised holdings, whereby moneys which are invested (ostensibly on loan) are in turn used to invest in other securities, and which are often backed by the resulting pool of securities (e.g. in the case of mortgage backed securities). Consideration should be given to whether exposures to particular counterparties should be aggregated. For example, if a superannuation fund holds $50M worth of Westpac shares, $30M of Westpac hybrid debt securities and $20M in Westpac term deposits, and has a $100M exposure to Westpac for currency hedging purposes, how should this be disclosed: should each holding be disclosed individually or on an aggregated basis, to best reflect the fund’s exposure to Westpac?

2.8 Large superannuation funds have exposure to a large number of securities, especially for options that have an allocation to international equities and/or which have portfolios managed on a passive basis (i.e. because those portfolios would include exposure to virtually all the securities in the relevant benchmark index which the portfolio tracks). It would not be unusual for a large superannuation fund to have exposure to more than 15,000 securities. The Committee queries the practicality and usefulness of publishing a list which contains over 15,000 entries on a website.

2.9 The Committee queries the usefulness to members of disclosing the number of shares and the price per share, as contemplated by the Explanatory Memorandum. Disclosing the price per share raises a separate question as to how international holdings should be quoted (i.e. in Australian dollars or in native currencies).

2.10 In light of the above, assuming that there is to be an obligation to disclose underlying portfolio holdings, the Committee queries whether it would be more useful to disclose:

(a) only the top 20 or top 50 holdings; and

(b) the percentage of the relevant option’s assets which has been invested in those securities (rather than the number of shares and price per share).

This would be a sensible exercise of the power to prescribe a materiality threshold, as contemplated by the proposed section 1017BB(4).

2.11 In any event, the fact that different funds hedge their foreign currency exposure differently and how this affects the disclosure of underlying holdings also needs to be considered. To illustrate the significance of the point, take a simple example involving two superannuation funds.

(a) Let's say both superannuation funds (each with $100M in assets) choose to invest $50M into an Australian ETF and $50M into a US ETF on 1 January and, for simplicity, assume that 1 AUD = 1 USD at this time.

(b) Assume that superannuation fund #1 fully hedged its currency risk, but that superannuation fund #2 did not hedge any of its foreign currency risk.

(c) On day 1, both funds would report that they held 50% of their assets in the Australian ETF and 50% of their assets in the US ETF.

(d) If equity markets were totally flat for the next 6 months, at the next 30 June reporting date, each fund would still have 50M AUD invested in the Australian ETF and 50M USD invested in the US ETF.

(e) However, if currency markets moved 10% during that market, such that $1 AUD = $1.10 USD at the 30 June reporting date, the value (in Australian dollars) of the investment into the US ETF would be significantly different for the two funds. Because superannuation fund #1 had fully hedged its currency risk, the value of its investment in the US ETF would still be $50M AUD. However, for superannuation fund #2, the value of its investment into the US ETF would be only $45M AUD. Superannuation fund #1 would still report that it had invested 50% of its assets into the Australian ETF and 50% into the US ETF. However, for superannuation fund #2, it is unclear whether it should disclose a 50/50 allocation, or that it had invested 53% of its assets into the Australian ETF and only 47% into the US ETF.

2.12 The use of other kinds of derivatives also needs to be considered, such as the use of SPI futures to equitise cash and holdings of call options and put options. For example, if a fund has $100M to deploy into the Australian equities market, it can either acquire physical holdings of shares or, alternatively, buy $100M of Australian SPI futures. In the case of the latter, is it the intention that superannuation funds report their indirect effective exposure to each of the stocks in the index (since the performance of those stocks is what will drive the performance of the SPI futures position), or is it the intention that futures positions be disclosed separately? The same ambiguity would arise when superannuation funds sell down exposure to a market by selling SPI futures (rather than immediately selling their physical holdings). In this case, funds would be overstating their position if they simply disclosed their physical holdings without adjusting for the (short) futures position. Holdings of call options and put options over particular stocks raise similar issues.

2.13 Some superannuation funds offer investment options which are entirely (or substantially) managed on a passive or indexed basis. This means that the holdings of the investment option would closely mirror the composition of benchmark indices. In almost all cases, the relevant benchmark licensing agreements (which are usually governed by New York law) would include strict confidentiality provisions which prohibit the disclosure of information concerning the composition of the benchmark, since this constitutes valuable proprietary information of the benchmark manufacturer (for example, MSCI, FTSE or Standard & Poor's). As such, compliance with the proposed legislation would cause some superannuation funds and their trustees to breach the terms of their licensing agreement, exposing them to the risk of termination of the relevant agreement (which would affect the ongoing management of the relevant investment option) and the risk of being sued for damages for breach of contract. The fact that the legislation allows for a 90 day lag following each 30 June and 31 December does not address the breach of contract and third party liability issues. The legislation should therefore include an additional defence for trustees who did not comply with the reporting obligations on account of third party contractual restrictions. Analogous difficulties will arise in the case of ETFs (exchange traded funds), which are predominantly operated as indexed funds and passively managed. The operators of these funds are likely to be highly resistant to disclosing precise details of their underlying holdings (possibly due to the restrictions in their own licensing agreements with benchmark providers or for their own commercial reasons) and, because ETF securities are traded on-market, superannuation funds would have no direct relationship with the ETF provider off which they could leverage for the purposes of negotiating access to the relevant data. The proposed legislation may create an impediment to superannuation funds investing in ETFs (i.e. because trustees may be unable to comply with their obligations if they do), which could frustrate the substantial efforts and expenditure by the ASX to foster growth in the Australian ETF market, which is still in its early stages.

Look through obligations

2.14 The Committee notes that there is nothing in the proposed section 1017BC which limits it to the superannuation context. Technically, it requires every custodian (even in a non-superannuation context) to notify third parties that they are receiving third party assets, even if this is not in fact the case.

2.15 Further clarification is required as to when trustees are required to look through an investment vehicle for the purposes of disclosing underlying holdings and when they are not required to do so. For example, the provisions which are proposed to be included in the Financial Sector (Collection of Data) Act seem to focus solely on investments in managed investment schemes, pooled superannuation trusts and other trusts. However, this overlooks other structures, such as corporate vehicles (e.g. LICs / listed investment companies) and limited partnerships. In contrast, the proposed section 1017BB of the Corporations Act is not limited in any way, and requires disclosure of underlying holdings which are in any way derived from the assets of a superannuation fund. This would require

disclosure on a look through basis where superannuation funds have invested in companies and limited partnerships. This being the case, it raises a question of when the look-through ceases. For example, if a superannuation fund were to invest in BHP Billiton shares (which they all do), the proposed section 1017BB would technically require superannuation funds to require the disclosure of all (listed and unlisted) investments held by BHP Billiton (and, in turn, all listed and unlisted investments held by those entities), which surely could not be the intention.

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.