Benchmarking Australian Superannuation Regulation and Practice

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Executive summary

This paper was written at the request of the Joint Parliamentary Committee on Corporations and Financial Services, to provide background for their inquiry into the structure and operation of the superannuation industry under the *Superannuation Industry (Supervision) Act 1993*.

One of the terms of reference for this inquiry was 'benchmarking Australian superannuation against international practice and experience'. The Committee considered that the retirement savings industry in the United Kingdom and the United States would be the most appropriate countries against which to benchmark the Australian industry.

The Committee is interested in a number of specific areas mentioned in its terms of reference and this paper seeks to benchmark Australia against the UK and US in these areas. Further, it provides additional comments on topics of specific interest to individual members of the Committee.

When benchmarking the Australian industry and regulation against that of the UK and the US, due allowance has to be made for the significant differences between the retirement savings systems of each country. Generally, the Australian system seeks to facilitate the accumulation of a retirement benefit, mainly by way of accumulation (or defined contribution) funds. The benefit may be taken as either a pension or a lump sum or as a combination of both. The retirement savings system in the UK is strongly directed towards the accumulation of a pension benefit, traditionally through a defined-benefit fund, though defined-contribution funds are becoming more important. Likewise, the US system has traditionally sought to provide a retirement pension, mainly through defined-benefit funds provided by employer sponsors. As with the UK, defined-contribution funds are becoming far more important in the US.

Allowing for these differences, in the majority of the areas nominated by the Committee Australian regulation of the superannuation industry compares favourably with that of the UK and US.

However, compared with the retirement systems of either the UK or the US, additional attention may need to be given to the following areas of the Australian retirement savings system:

- the provision of retirement advice by advisors closely associated with the superannuation fund provider;
- the exercise of a superannuation fund trustee's responsibility to prudently manage a fund's assets in an environment of member investment choice;

- possible restrictions on employing foreign nationals on a temporary basis, arising from Australia’s lack of a social security and superannuation agreement with other countries, notably the UK;
- whether Australian standards for a fit and proper person to be a superannuation fund trustee should include standards relating to prior or future convictions for offences against another person, or offences in relation to prohibited substances;
- whether the trustees of a superannuation fund should have the obligation to report missing contributions from an employer, instead of the Australian Taxation Office discovering this omission during its routine operations or having the matter raised by the affected individuals; and
- whether those trustees who only hold a Registrable Superannuation Entity licence should be required to maintain an appropriate internal dispute resolution mechanism, in the same way that trustees who are holders of an Australian Financial Services licence are required to do.

Section 1: Introduction

1. On 30 June 2006 the Parliamentary Joint Committee on Corporations and Financial Services (the Committee) resolved to inquire into the superannuation industry. The inquiry broadly relates to the structure and operation of the industry under the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) and includes fifteen specific topics of interest.

2. The inquiry's terms of reference indicate that the Committee will inquire into the structure and operation of the SIS Act and the superannuation industry to ensure that it provides an efficient, effective and safe regulatory structure for the management of superannuation funds.

3. The Committee was of the view that it would assist its inquiry to request the Parliamentary Library to prepare a research paper regarding term of reference 13: 'Benchmarking Australia against international practice and experience'.

4. On 7 July 2006 the Library received a formal request to undertake specific research on superannuation regulation in support of the Committee's inquiry. After the Committee's review of the first draft, comments on additional topics were added to the paper.

Committee's interests

5. In adopting the terms of reference, the Committee noted the importance of international experiences. The committee noted that the two most relevant jurisdictions were the United Kingdom (UK) and the United States of America (US).

6. In response to an initial paper, Committee members indicated that they wished to receive a broad descriptive paper, focusing on specific comparisons arising from the Committee's terms of reference for this particular inquiry.

Purpose

7. The purpose of this paper is to provide the Committee with background on a number of issues raised in the terms of reference by comparing relevant features of the retirement income systems of Australia, the UK and the US.

Structure of the paper

8. The paper is divided into three major sections with various subsections. Section 2 is an overview of each country's retirement income system, which addresses:

- the broad description of the retirement systems of Australia, the United Kingdom and the United States of America
- the role played by private retirement savings in each system
- how private retirement savings are managed in each country (role of trustees), and
- the regulators and their legal framework in Australia, United Kingdom and the United States of America

9. Section 3 is a comparative analysis of specific topics arising from the Committee's terms of reference, addressing:

- regulatory overlaps – do they occur and how serious are they;
- capital requirements for trustees;
- investment advice;
- how advice is paid for in each country;
- fees and charges;
- investment choice in each country;
- responsibility of the trustee in member investment choice;
- the shift to defined contribution funds;
- funding arrangements for regulation in each country;
- presence of 'for profit' or 'not for profit' retirement funds in each country; and
- double superannuation coverage.

10. Section 4 considers the arrangements for the safety of savings in each country, addressing:

- compensation for theft, fraud, employer insolvency or withdrawal of plan sponsorship;
- trustee membership – 'fit and proper person' rule;
- trustee licensing;
- employee/employer representation;
- the role of trustees – in whose interests are retirement savings schemes managed;
- the role of trustees – 'prudent person' rule;
- risk management, including the following topics:

- in-house asset rules;
- vesting;
- disclosure – informing members;
- the role of auditors;
- missing contributions; and
- handling complaints.

11. The paper focuses on the regulatory framework for the above matters in each country.

Section 2 – Overview of each country's system

Broad description of the retirement systems of Australia, the UK and the US

Australia

12. Australia has a three-pillar pension system. The tax-funded public pension (Age Pension) is the first pillar. It does not require a direct contribution from its recipients. This pension is payable to men at age 65 and to women at 63, gradually increasing to 65 by 2014. The Age Pension is a flat rate, means tested, with a comparatively low replacement rate compared to a person's pre-retirement income, aiming essentially to prevent poverty. The second pillar involves the Superannuation Guarantee (SG), introduced in 1992. With few exceptions the SG requires employers to provide a minimum level of pension contributions, currently set at 9 per cent of wages, for all employees earning above a (low) threshold level of wages. The earliest age for access to superannuation benefits is 55 years. A phased increase in the preservation age (the age until which the benefits must be preserved in a superannuation fund) to 60 will be implemented between 2015 and 2025. The third pillar is made up of private savings, mainly voluntary superannuation contributions, encouraged by tax concessions including incentives such as the ability of the self-employed to claim a tax deduction, and government superannuation co-contributions for low to middle income earners.[1]

United Kingdom

13. As in Australia the current UK pension system also has three tiers (or pillars). The first tier is contributory, but benefits are paid at a flat rate. The system is financed on a 'pay as you go' basis with contributions set at a level broadly necessary to meet the expected expenditure in the same year. There is a significant range of means-tested benefits available to lower-income pensioners. The second tier is made up of employer/employees contributions to a pension scheme and is mandatory for all employees, though there is a wide range of choices in how a person participates in these arrangements. For example, a contributor can receive the 'state second pension' or can choose to opt out of these arrangements and contribute to a private occupational pension fund. Apparently, about 50 per cent of employees 'opt out' of government second-tier arrangements.[2] The state second pension is funded on a 'pay as you go' basis through a person's National Insurance contributions, which vary according to

[1] OECD, *Economic Surveys*, 'Australia', vol. 2006, no. 12, July 2006, p. 145.

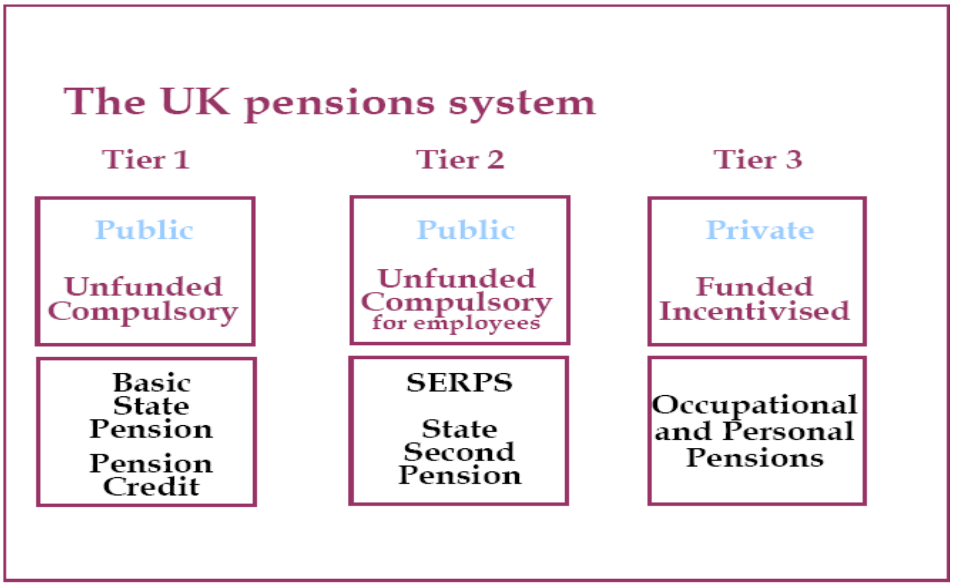
[2] Hazel Bateman and Geoffrey Kingston, 'Comparative Performance of Retirement Income Systems in the Anglosphere', paper presented at symposium on Australia's Superannuation System – Accounting, Accountability and Performance, 22 April 2005, University of Queensland, Brisbane, revised July 2005, p. 22. Recent surveys by the UK Pension Commission suggest a lower figure, less than 50 per cent of employees have non-state retirement savings.

income. Private-sector occupational schemes are financed on a fully-funded basis. The third tier is made up of voluntary private savings and the benefits are financed on a fully-funded basis.[3]

14. State pension benefits are payable from the age of 65 for men and 60 for women. The state pension age for women is due to increase gradually from 60 to 65, between 2010 and 2020. Further, increases of the state pension age to 68 have been announced. Benefits can be deferred for an enhancement to the ultimate pension.

15. The following diagram is a simplified representation of the current UK retirement-income system.

Figure 1: UK retirement-income system – simplified version


The UK pensions system
Tier 1
Tier 2
Tier 3
Public
Unfunded Compulsory
Public
Unfunded Compulsory for employees
Private
Funded Incentivised
Basic State Pension
Pension Credit
SERPS
State Second Pension
Occupational and Personal Pensions

Source: UK Pension Policy Institute, ‘The Pensions Primer’, updated May 2006, p. 1.

NB In the above diagram ‘SERPS’ stands for ‘State Earnings Related Pension Scheme’. The State Second Pension replaced SERPS in 2002. In the above diagram the second tier is described as unfunded, and this is largely true, since any employee contributions do not meet the cost of the resulting pension.

[3] OECD, *Ageing and Employment Policies, United Kingdom*, 2004, p. 64.

United States

16. The US retirement-income system also has three main components. The first is a contributory social-insurance program popularly known as 'Social Security'. It is financed almost entirely from employer and employee contributions, of 12.4 per cent of wages, evenly divided between both. The second component is the employer-sponsored retirement programs. Traditionally, these have been defined-benefit plans. However, defined-contribution plans (i.e. accumulation plans in Australian terms) have become increasingly prominent.

17. The most popular type of defined-contribution scheme is the 401K funds, the title referring to the section in the US Internal Revenue Code under which these funds operate. Briefly, the 401K rules allow up to US$15 000 per annum (in 2006) of a person's salary to be contributed to a fund tax-free. The benefits are subject to normal income tax upon payment. The employer may, or may not, make matching contributions. There are several variations on these rules. For example with a 'Roth 401K', contributions are taxed but the benefits are tax-free.[4]

18. The third component is individual retirement-savings accounts.[5] The full US social security pension (the first component) is available when a person retires at 65, rising gradually to 67 for those born in or after 1960.[6]

Comment

19. The significant differences in retirement policy arrangements of the three systems result in the different regulatory approach in each country. The first and second 'pillars' in the Australian and the UK systems are mandatory. All Australians have access to the Age Pension (if they are eligible under income and assets tests) and all employers whose employees earn over $450 per month, are required to contribute 9 per cent of their wages on their behalf to a superannuation fund of the employee's choosing. In the UK all residents have access to the standard British Social Security Age Pension from the relevant age. All employees participate in the UK's second-pillar arrangements, either by the 'second state pension' or by opting out of government benefits. However, in the US only the first pillar is mandatory. All US residents have access to that country's basic social security pension (if they are otherwise eligible under that country's income test). However, only 60 per cent of

[4] James R. Story, 'Retirement Plans with Individual Accounts: Federal Rules and Limits', Congressional Research Service, Library of Congress, 27 February 2003, updated in 2006, pp. 5–6.

[5] Lawrence H. Thompson, 'US Retirement Income System', *Oxford Review of Economic Policy*, vol. 22, no. 1, Spring 2006, pp. 96–100.

[6] ibid., p. 97.

employees are offered participation in their employer's retirement-benefits scheme.[7] This will change with the recently legislated US *Pension Protection Act 2006*. This Act allows for the automatic enrolment of employees into occupation-based retirement-savings plans.[8]

20. The US also differs significantly from Australia and the UK in that major regulatory legislation, the *Employee Retirement Income Security Act 1974* (ERISA) sets minimum standards for pension plans in private industry. ERISA does not require any employer to establish a pension plan. It only requires that those who establish plans must meet certain minimum standards. The law does not specify how much money a participant must be paid as a benefit. ERISA requires plans to regularly provide participants with information about the plan including information about plan features and funding; sets minimum standards for participation, vesting, benefit accrual and funding; requires accountability of plan fiduciaries; and gives participants the right to sue for benefits and breaches of fiduciary duty. ERISA also guarantees payment of certain benefits through the Pension Benefit Guaranty Corporation (PBGC), a federally chartered corporation, if a defined-benefit pension plan is terminated.[9]

21. The public pension system in the UK is unusual in several ways, most notably in having an earnings-related pension tier in which private providers operate in parallel with (as an opt-out from) the state system rather than as an additional tier. Further, the UK's pension policy has also been characterised by frequent changes, especially regarding rules governing the interaction between the state earnings-related pension and private alternatives.[10] The UK's system is by far the most complex of the three considered in this paper.

22. The retirement-income systems of the US and UK differ from Australia's in that there is greater formal focus on retirement pensions in the former countries. For example, only 25 per cent of a UK retirement benefit can be taken as a lump sum upon retirement; and in the US there has traditionally been a greater focus on pensions paid by the employer. In Australia both tax and social security (first-tier) arrangements encourage the taking of retirement benefits as an income stream, but it is not mandatory to do so. Consequently, the regulation of the US and UK retirement-income systems focuses mainly on the regulation of the

[7] Barrie Dunstan, 'Super Lesions for US mutual funds master', *Australian Financial Review*, 14 August 2006, p. 54, citing Paul Schott Stevens, President of the Investment Company Institute of the US, the industry body covering US mutual funds and other collective investments.

[8] US *CCH Tax Briefing*, 'Congress Passes Comprehensive Pension Reform Bill', 4 August 2006, http://tax.cchgroup.com/Legislation/2006-Pension.pdf, accessed on 16 August 2006.

[9] US Department of Labour, 'The Employee Retirement Income Security Act', http://www.dol.gov/compliance/laws/comp-erisa.htm, accessed on 22 March 2007.

[10] R. Kent Weaver, Centre for Retirement Research, Boston College, *The Politics of Parallel Pensions: Lessons from the United Kingdom for the United States*, Research undertaken for the US Social Security Administration, February 2006, p. 2.

provision of pension benefits. In contrast, the regulation of the Australian retirement-income system focuses mainly on the provision of a benefit; which may be used in any way the retiree sees fit, including the provision of a pension or the payment of a lump sum.

The role of private retirement savings

23. A common element across the three retirement systems is the significant role played by private savings in the provision of retirement incomes. By private savings, we mean the accumulation of retirement benefits in addition to benefits provided by the relevant government. Such savings can come from either employer-sponsored plans or an individual's own savings. They can be either defined-benefit or defined-contribution arrangements. Comparing the regulation of private savings allows useful international comparisons to be made.

How private retirement savings are governed (role of trustees)

24. Research undertaken by the Organisation for Economic Co-operation and Development (OECD) has identified a number of types of retirement-savings-fund governance. In Australia, the UK and the US the dominant form of pension-fund management is that of a trust.[11]

25. In the trust, legal title to the retirement-savings-fund's assets is vested in trustees, who are the governing body of the fund. Trustees must administer the trust assets in the sole interest of the plan participants, who are the beneficiaries from the investment of those assets according to the trust deed. The basic principle of trust law is that the assets of each trust must be segregated from the assets of all other trusts administered by the trustee and from the trustee's own assets. All Anglo-Saxon countries (Australia, Canada, Ireland, New Zealand, United Kingdom, and United States) recognise the trust as the main or only legal form for pension funds.[12]

26. However, the role of trustees in the management of retirement savings in the US and UK may be changing. In the US, it is possible for plan sponsors to set up pension funds where the trustee is devoid of any operational or governance responsibilities except holding title to the assets. The governing body is then the plan sponsor and/or some third party, who

[11] OECD, Directorate for Financial, Fiscal and Enterprise Affairs Insurance Committee, Working Party on Pensions, *Pension Fund Governance* (Note by Secretariat), DAFFE/AS/PEN/WD(2000)14/REV2, 6 December 2001, pp. 5–6.

[12] ibid., p. 6, also Bateman and Kingston, op. cit., p. 19.

therefore have the fiduciary responsibility for that fund. Where the pension funds are administered by third parties, the trust form is equivalent to the contractual form in everything but name.[13] In the UK, some plan sponsors are sidestepping complex trust-based arrangements and establishing new retirement-savings arrangements based on insurance contracts for the management of employer/employee second-tier private retirement savings.[14]

The regulators and their legal framework

27. Despite trust law having an extensive and comprehensive period of development, the trustees of retirement savings funds in each country are subject to specific pieces of legislation. Specific regulators have been given the task of administering these laws.

Australia

28. The regulation of retirement savings in Australia is undertaken by three agencies. The main agency is the Australian Prudential Regulation Authority (APRA). Significant regulatory activity is also undertaken by the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO).

29. The main pieces of legislation are:

- the Superannuation Industry (Supervision) Act 1993 (the SIS Act) and associated regulations;
- the *Corporations Act 2001* (Corporations Act) and associated regulations;
- the Income Tax Assessment Act 1997 (ITAA97); and to a lesser extent
- the Income Tax Assessment Act 1936 (ITAA36).

30. Prudential legislation and regulations, administered by APRA (except in relation to Self Managed Superannuation Funds (SMSFs)), are directed at safeguarding the assets of superannuation fund members and investors. Disclosure legislation and regulations,

[13] OECD, Directorate for Financial, Fiscal and Enterprise Affairs Insurance Committee, Working Party on Pensions, *Pension Fund Governance* (Note by Secretariat), op. cit., p. 6.

[14] M. Scott Donald, Director of Research (amongst other roles), Frank Russell Company (UK), 'The Prudent Eunuch: Superannuation trusteeship in an environment of member investment choice', paper presented to the 14th Australian Colloquium of Superannuation Researchers, 20–21 July 2006, University of New South Wales, Sydney.

administered by ASIC, are directed at ensuring that fund trustees provide relevant information to superannuation fund members to help them make informed decisions.

31. Briefly, taxation legislation and regulations, administered by the ATO, are directed at superannuation funds and their members to collect revenue for the Commonwealth of Australia. The ATO also administers the superannuation co-contributions, SG and choice regimes and regulates SMSFs.

United Kingdom

32. In the UK the regulation of private retirement savings is undertaken by two bodies, the Pensions Regulator and the Financial Services Authority (FSA). Each body has distinct roles in regulating retirement savings.

33. The *Pensions Act 2004* gives the Pensions Regulator a set of specific objectives:

- to protect the benefits of members of work-based pension schemes;
- to promote good administration of work-based pension schemes; and
- to reduce the risk of situations arising that may lead to claims for compensation from the Pension Protection Fund.[15]

34. The UK Pensions Regulator commenced operation on 6 April 2005, replacing the Occupational Pensions Regulation Authority. Its focus on work-based pensions restricts its regulatory activity to the UK's second-tier private pension funds sponsored by an employer. The main associated regulations are summarised in the UK Pensions Regulator's Regulatory Guidance.[16] This appears to be a similar role to that of APRA in the Australian superannuation market, save that APRA also regulates superannuation funds that are not linked to the workplace.

[15] The Pensions Regulator, 'Our Objectives', http://www.thepensionsregulator.gov.uk/aboutUs/objectives.aspx, accessed on 4 August 2006, and subsection 5(1), *Pensions Act 2004* (UK).

[16] For further information, see the Codes of Practice and Regulatory Guidance sections of the UK Pensions Regulator's website, http://www.thepensionsregulator.gov.uk/.

35. The other major piece of legislation applying to the management of retirement savings in the UK is the *Pensions Act 1995*. It mainly governs the operation of occupational pension schemes and the trustees who operate these schemes. It is also administered by the Pensions Regulator. Other relevant UK legislation is the *Pension Schemes Act 1993*.

36. The *Financial Services and Markets Act 2000* (FSM Act) gives the FSA four statutory objectives:

- maintaining market confidence in the financial system;
- promoting public understanding of the financial system;
- securing the appropriate degree of protection for consumers; and
- the reduction of financial crime: reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.[17]

37. The FSA states that it does not regulate UK corporate pension funds, but from 6 April 2007 it will have full regulatory responsibility for both 'Self Invested Personal Pension'(SIPP) (something like Australian SMSFs) and retail personal pension funds.[18] Further, it provides a wide variety of consumer information on investment in UK pension funds.[19] Again, this appears to be a similar role to that of ASIC in Australia, save that the ATO regulates the Australian equivalent to the UK SIPPs.

United States

38. In the US, workplace retirement-savings arrangements are administered by the Federal Department of Labour's Employee Benefits Security Administration (EBSA) (formerly the Pension and Welfare Benefits Administration). Its 'mission statement' is as follows:

[17] UK Financial Services Authority, 'Statutory Objective', http://www.fsa.gov.uk/pages/About/Aims/Statutory/index.shtml, accessed on 4 August 2006.

[18] For example, UK Financial Services Authority, 'Financial Risks Outlook 2006', p. 53, http://www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2006.pdf, accessed on 4 August 2006, and *FSA publishes feedback on regulation of personal pensions*, media release, 29 September 2006, http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/099.shtml.

[19] For example, UK Financial Services Authority, 'Pensions made clear', http://www.moneymadeclear.fsa.gov.uk/pensions, accessed on 4 May 2007.

- assist workers in getting the information they need to exercise their benefit rights;
- assist plan officials to understand the requirements of the relevant statutes in order to meet their legal responsibilities;
- develop policies and regulations that promote the growth of employment-based benefit;, and
- deter and correct violations of relevant statutes through strong administrative, civil and criminal enforcement to ensure workers receive promised benefits.[20]

39. The main piece of legislation administered by the EBSA is the US *Employee Retirement Income Security Act 1974* (ERISA). This Act regulates employers who offer pension or welfare benefit plans for their employees. Title I of this Act is administered by the EBSA and imposes a wide range of fiduciary, disclosure and reporting requirements on fiduciaries of pension and welfare benefit plans and on others having dealings with these plans. These provisions pre-empt many similar US state laws. Under Title IV of this Act, certain employers and plan administrators must fund an insurance system to protect certain kinds of retirement benefits, with premiums paid to the federal government's PBGC.[21]

40. Portions of ERISA are codified in various places of the United States Code, including 18 U.S.C. ch. 29, and Internal Revenue Code sections §219 and §408 (relating to the Individual Retirement Account) and sections §410 through §415, and §4971, §4974 and §4975. For those not familiar with the US system, this way of organising legislation can be confusing.[22]

41. Like the UK FSA, the US Securities and Exchange Commission does not appear to have a formal role in regulating US retirement savings. Rather, its mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[23] Its overall activities have a major impact on the regulation of retirement savings.

[20] US Department of Labour, Employee Benefits Security Administration, 'Organization Chart', http://www.dol.gov/ebsa/aboutebsa/org_chart.html#mission, accessed on 4 May 2007.

[21] US Department of Labour, 'Summary of the Major Laws of the Department of Labor', http://www.dol.gov/opa/aboutdol/lawsprog.htm, accessed on 4 May 2007.

[22] An alternative source for ERISA is http://www4.law.cornell.edu/uscode/html/uscode29/usc_sup_01_29_10_18.html, accessed on 8 August 2006.

[23] US Securities and Exchange Commission, 'What we do', http://www.sec.gov/about/whatwedo.shtml, accessed on 8 August 2006.

42. The US Treasury's Internal Revenue Service is responsible for ensuring compliance with the Internal Revenue Code, which establishes the rules for operating a tax-qualified pension plan, including pension-plan funding and vesting requirements.[24]

Comment

43. From this brief overview several points emerge:

- formally, Australia has the most complex regulatory arrangements in respect of retirement savings, with APRA, ASIC and the ATO all having significant formal roles in their regulation;
  - Australia has a complex legislative framework, with three major pieces of legislation (Corporations Act, SIS Act and Income Tax Assessment Acts 1936 and 1997) and associated regulation applying to the governance of retirement savings;
  - while ASIC covers the consumer protection aspects, APRA covers the prudential operation of superannuation funds. While this division of responsibilities plays to each organisation's perceived strength, it is a potential cause of regulatory overlap;
- however, successive changes in the UK's retirement arrangements have led to an equally complex legislative framework to that of Australia. The Pension Acts of 1993, 1995 and 2004, as well as the FSM Act, and associated regulations at first glance present an equally difficult set of legislative requirements to navigate. Potentially, UK pension funds have to deal with the Pensions Regulator and the FSA;
- the United States appears to have the least complex regulatory agencies and legislation applying to retirement savings. However, at least three regulatory agencies potentially have an impact on the operation of the US retirement-income system: the EBSA, the IRS and the SEC; and
- the respective regulatory frameworks may reflect the different structures and types of benefits paid by the retirement-savings industry in each country. Australia and the UK require compulsory contributions to employees' retirement funds and this requirement alone leads these countries to heavily regulate their respective retirement-income systems.

[24] US Department of Labour, 'Frequently Asked Questions About Pension Plans and ERISA', http://www.dol.gov/ebsa/faqs/faq_compliance_pension.html, accessed on 4 May 2007. The author understands that the US Department of Labour has jurisdiction over the prohibited-transaction provisions of Title II of ERISA. However, the US Internal Revenue Service generally administers the rest of Title II of ERISA, as well as the standards of Title I of ERISA that address vesting, participation, non-discrimination, and funding in Parts 2 and 3 of Title 1.

In contrast, the non-compulsory nature of the US system places fewer obligations on the US government to protect benefits (but such protection is not at all absent).

44. A significant difference between Australia and the other two countries is the role of the Australian Taxation Office (ATO). Its role in regulating the Australian superannuation system goes beyond that of the tax authorities in the other two countries. There are several reasons for this. Firstly, the ATO's role in supervising SMSFs. It is now the sole regulator of such entities. Secondly, a major proportion of regulations governing the operations of Australian superannuation funds is located in the income-tax legislation administered by the ATO. Thirdly, the ATO administers significant portions of the overall superannuation system, apart from the collection of the required tax (i.e. the SG, co-contributions and choice regimes).

45. In contrast, the US Internal Revenue Service has some jurisdiction over non-tax elements of the US retirement system, but not over a whole group of funds. The UK tax authority's role appears to be limited to the imposition and collection of the required amounts of tax from that country's retirement funds.

Section 3: Comparative Analysis – Specific Topics

Regulatory overlaps – do they occur and how serious are they?

46. For the purposes of this paper regulatory overlap is the undertaking of similar functions by different agencies in relation to the same industry or activity. Where there are two or more regulators, unless great care is taken, the potential for regulatory overlap exists.

Australia

47. As suggested above, prima facie, Australia has the most complicated regulatory arrangements for retirement savings. Recently the Taskforce on Reducing Regulatory Burdens on Business found significant overlaps in Australia's regulation of retirement savings.[25] A relevant extract from their report is at Attachment 1.

United Kingdom

48. As noted above, the FSA has declared that it does not regulate workplace based pension savings funds. As the UK Pensions Regulator has recently commenced operation it may be too early to judge whether significant regulatory overlaps occur in the UK.

United States

49. As there is one major regulator of occupational based retirement savings in the US the incidence of significant regulatory overlap by different agencies is likely to be slight. The author understands that there is a clear regulatory demarcation between the role of the Internal Revenue Service and the EBSA.

Capital requirements for trustees

50. For the purposes of this paper the capital requirements of a trustee is the level of easily accessible net assets that a the trustee of a retirement savings fund (as an individual, group of individuals or corporate entity) is required to maintain in order to carry out its role. Generally, the requirements apply to retirement savings funds open to the public or large

[25] Australian Government, *Rethinking Regulation: Report of the Taskforce on Reducing the Regulatory Burdens on Business*, January 2006.

funds available to members of a particular industry or employees of a particular company. They do not apply to smaller funds, such as SMSFs in Australia or Small Self Administered Schemes in the UK.

Australia

51. From 1 July 2006 only corporate trustees having an RSE licence can act as the trustee of a superannuation fund. The required capital amount is not less than $5 million for the trustees of a public offer superannuation fund.[26] This capital is to be held as net tangible assets as defined in the regulations.[27] Essentially, the definition requires that these assets be readily available.

52. The Australian net tangible asset requirements have a threefold purpose. They provide some financial resources to act as a buffer against risk; they evidence a commitment on the part of a trustee to its superannuation business; and they act as an incentive to the trustee to manage the entity well. APRA believes that it is appropriate that a trustee has ready access to these resources at times of stress. This can be best demonstrated where net tangible assets are kept in a form which can be used to support the financial needs of the RSE licensee (or approved trustee).[28]

United Kingdom

53. Unlike Australia, there appears to be no capital requirements for trustees of a UK occupational pension fund.

United States

54. US trustees or appointed fiduciaries for a workplace retirement savings plan are required to post a bond of about 10 per cent of the money for which they are responsible (i.e. handled), but in any case this bond cannot be less than US$1 000 or more than US$500 000,

[26] Superannuation Industry (Supervision) Regulations 1994 3A.04(1) and s.29DA *Superannuation Industry (Supervision) Act 1993*.

[27] Superannuation Industry (Supervision) Regulations 1994 3A.04(2).

[28] Australian Prudential Regulation Authority, Superannuation Guidance Note SG150.1 Capital Requirements - Net Tangible Assets, *Guidance Notes and Circulars*, July 2004, p. 5, at http://www.apra.gov.au/Superannuation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=7366 (accessed 9 August 2006).

except where the US Secretary for Labour otherwise determines.[29] From 31 December 2007 the recently legislated US *Pensions Security Act 2006* increases the maximum bond to $US1m for plans that hold approved employer securities, which are securities associated with the employer sponsor.[30] The purpose of these bonds is to protect against the consequences of fraud or dishonesty on the part of the plan fiduciary.[31] There are several exceptions to this requirement for corporate fiduciaries or organisations that are already subject to US State or Federal supervision.

Investment Advice

55. The investment advising industry in each country is well developed. In Australia ASIC regulates the provision of financial advice through its adviser licensing regime. A broadly similar regime operates in the UK where financial advisers are required to be licensed to provide advice by the FSA. In the United States investment advisers are required to be registered with the US Securities and Exchange Commission (SEC).[32] The main US legislation is the US *Investment Advisors Act 1940* (Advisors Act), administered by the SEC.[33] US investment advisors are also subject to US State laws and regulations.

56. There is a marked trend in Australia and the US for retirement funds to offer their members investment advice. In the US the new *Pensions Protection Act 2006* permits 401K

[29] US Code Title 29, Chapter 18, Subchapter I, Subtitle B, Part 4, §1112(2) http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001112----000-.html (accessed 30 august 2006).

[30] Staff of US Joint Committee on Taxation, TECHNICAL EXPLANATION OF H.R. 4, THE “PENSION PROTECTION ACT OF 2006,” AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, p. 146 at http://www.house.gov/jct/x-38-06.pdf (accessed 31 August 2006)

[31] US Federal Regulations, § 2580.412-8 The nature of the duties or activities to which the bonding requirement relates’, at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=ec6433b3ca9732508926eb475b12f876&rgn=div8&view=text&node=29:9.1.3.9.10.2.21.2&idno=29 (accessed 30 August 2006).

[32] US Code, Title 15, Chapter 2D, Subchapter II –Investment Advisers, §80b-3, at http://www4.law.cornell.edu/uscode/html/uscode15/usc_sup_01_15_10_2D_20_II.html (accessed 16 August 2006).

[33] US *Investment Advisers Act of 1940* - This law regulates investment advisers. With certain exceptions, this Act requires that firms or sole practitioners compensated for advising others about securities investments must register with the Securities and Exchange Commission and conform to regulations designed to protect investors. Since the Act was amended in 1996, generally only advisers who have at least US$25 million of assets under management or advise a registered investment company must register with the Commission.

funds providers and similar providers to offer personalised investment advice to account holders. Generally, the investment advice arrangement must provide that any fees, including commission, received by the fiduciary advisor do not vary depending on the basis of any investment option selected or a computer model used for selecting and managing investments. Although providers can give personalised investment advice to account holders, they cannot advise employers about which funds and investments to include in their plans.[34] In Australia, large superannuation funds are now beginning to sponsor, or provide, investment advice to their members.[35] To date, the UK advisory industry appears to be separate from the pension fund management industry.

Payment for Advice

57. The appropriate method for payment for investment advice has been a significant Australian superannuation debate. Should those required to contribute to superannuation be charged for receiving advice, and if so, should it be by way of a flat hourly fee or by way of a commission based on the funds under advice? This section will examine the regulatory framework in each country governing the payment for advice relating to retirement savings.

Australia

58. Australian legislation does not prescribe how superannuation (or any other) investment advice is paid for. Rather, Australian legislation requires that the amounts paid for this advice, be it by way of fee or commission (or both) are clearly stated in the documents given to an investor.[36] These documents are 'Statements of Advice', 'Product Disclosure Statements' and other periodic statements given to investors. Generally, such information must be stated in dollar terms, as well as percentage of assets under advice terms. These requirements extend to the so called 'soft dollar' commissions paid, where advisers gain non-monetary payments in return for selling a product, such as help with office expenses or free travel.[37]

[34] US *CCH Tax Briefing*, 'Congress Passes Comprehensive Pension Reform Bill', 4 August 2006, at http://tax.cchgroup.com/Legislation/2006-Pension.pdf (accessed 17 August 2006).

[35] For example, Comsuper provides investment advice to those leaving the Commonwealth superannuation schemes. The author understands that other Australian superannuation funds provide the same type of service.

[36] Sections 1013C and 1013D, *Corporations Act 2001* and Australian Securities and Investment Commission, Policy Statement 182, *Dollar disclosure*, 15 December 2004, and PS 175, *Licensing – Financial product advisers – Conduct and disclosure*, 30 November 2005.

[37] Australian Securities and Investment Commission, Policy Statement 182, *Dollar disclosure*, ibid.

United Kingdom

59. Like Australia, UK legalisation does not prescribe the method by which investment advice is paid for. The FSA requires that whether a fee or a commission is charged the maximum possible amount charged is clearly stated to the consumer before the advice is given or the services provided, by way of ‘Initial Disclosure Document’, ‘Guide to Services’ and ‘Fees & Commissions Statement’. This information must be given at first contact with an advisor and must state the amount paid in terms of percentage of the amount invested and as a pound sterling amount paid. Further, the Fees and Commission Statement must also include the market average charges for the products offered by the adviser.[38] Specific information on the amount charged arising from investing in a specific product also must be provided.

60. In the UK the adviser is required to ensure that their fees and commissions are not excessive. Such charges are excessive when they are not in accordance with the general market rates for the service provided, taking into account the trust placed in the adviser and the extent to which these fees and commissions have been disclosed.[39]

United States

61. Like Australia and the UK, US legislation and regulation does not restrict the way in which an investment adviser is paid. The following comments apply to those investment advisers etc registered with the SEC and regulated under the Advisers Act. Generally, only those advisors who are responsible for more than $US25m are required to be registered with the SEC.

62. Fundamental to the Advisers Act is an adviser’s fiduciary obligation to act in the best interests of clients and to place clients’ interests before its own. As part of its fiduciary duty to clients, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to clients. Advisers are required to disclose any facts that might cause the adviser to render advice that is not disinterested. When an adviser fails to disclose information regarding potential conflicts of interest, clients are unable to make informed decisions about entering into or continuing the advisory relationship.

[38] Financial Services Authority, FSA Handbook, Release 041, April 2005, *Conduct of Business*, Part 4.3, Disclosing information about services, fees and commissions – packaged products, pp. 16 – 28, and Part 5.7 Disclosure of charges, remuneration and commission, pp. 46 - 57 at http://www.fsa.gov.uk/pubs/hb-releases/rel41/rel41cob.pdf (accessed 30 March 2007).

[39] ibid, p. 44

63. Examples of failures to disclose material information to clients would include circumstances where an adviser fails to disclose all fees that a client would pay in connection with the advisory contract, including how fees are charged, and whether fees are negotiable.[40]

Comment

64. Both Australia and the UK have specific requirements on the disclosure of an investment adviser's payments, as well as other related investment fees and/or commissions. However, Australian's basic requirements are enshrined in legislation supported by extensive guidance from ASIC. In contrast, the UK requirements are placed in enforceable regulation. It is not clear whether the placement of the basics requirements in legislation confers greater powers of enforcement on the relevant regulator.

65. In the UK, advisers must disclose their charges as both an amount paid, and as a percentage of the funds invested. Australia only requires that the charges be disclosed in dollar terms. This may be due to the widespread Australian industry practice of disclosing these charges, where paid via a commission, as a percentage of the funds invested and specific regulation on this point may not have been seen as being required. In this matter, it could be argued that Australia has a 'lighter' regulatory touch than the UK.

66. Neither the US or Australia places any formal ceiling on the amount paid for advice. The UK has an effective legal cap on the amounts charged, in that such charges must not be excessive, as defined by prevailing market rates paid for advice. It is not clear whether such regulation has placed an effective cap on the amounts paid for investment advice as market rates for such services may rise over time.

67. Finally, the US regulations are far less prescriptive, in that they do not formally address the question of how the disclosure of amounts paid for advice is handled (i.e. in dollar terms or as a percentage of funds under advice or both). However, it could be argued that the very imprecision of the US regulations on this matter actually extends the reach of the regulations, in that a wider range of conduct (or mis-conduct as the case may be) is potentially covered by these less prescriptive regulations.

[40] US Securities and Exchange Commission, *Letter from the Office of Compliance*, Inspections and Examinations: to registered Investment Advisors, on Areas Review and Violations Found During Inspections, 1 May 2000, at http://www.sec.gov/divisions/ocie/advltr.htm#FOOTNOTE_5 (accessed 30 March 2007). And US electronic code of regulations, Title 17 Commodity and Securities Exchanges, Chapter II Securities and Exchanges Commission, Part 275 Rules and Regulations – Investment Advisers Act of 1940, §275.204-3, *Written Disclosure Rules* at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=25e9c83622d2cfcabdbabbe02159af2c&rgn=div8&view=text&node=17:3.0.1.1.22.0.147.21&idno=17 (accessed 30 March 2007).

Investment Management Fees and Charges

68. Another significant issue is whether the level of fees and charges for the management of retirement savings should be set by regulation. Generally, Australia, the UK and the US do not regulate the level of fees and charges, preferring that competition between service providers keep these charges to the lowest level. Neither do these countries specify the way in which these fees are levied, so providers are free to set their fees by way of a set percentage of the funds under management, or impose a set dollar value of fees per year per fund member, or a combination of both methods.

69. There are some exceptions to the general approach. In Australia very small benefits, under $1000, cannot be reduced by fees and charges of any kind.[41] In the UK the management charges for stakeholder pension accounts must not be more than 1.5 per cent of the total value of the fund, reducing to 1 per cent a year after the first 10 years membership. The costs of some services provided, such as the cost of splitting the resulting pension payments between two parties who later divorce, can also be recovered from a stakeholder pension account.[42] Commissions paid to advisors must come out of the annual 1.5 per cent charge.[43] The take-up rate of these products in the UK has not been great.[44]

Investment Choice

70. Within the retirement savings area 'investment choice' means the choice of particular investment strategy, or asset classes, within a particular retirement savings scheme, in which a member's benefits are invested.

[41] Australian Prudential Regulation Authority, *Superannuation Circular* I.B.1 – Protection of Member Benefits, September 2000 at http://www.apra.gov.au/Superannuation/upload/I-B-1-Protection-of-Member-Benefits.pdf (accessed 24 April 2007).

[42] UK Pension Regulator, 'Stakeholder Pensions, *Fact Sheet*, 11 May 2005, at http://www.thepensionsregulator.gov.uk/stakeholderpensions/general/general-01.aspx (accessed 24 April 2007), and UK Department of Work and Pensions, the Pensions Service, Stake Holder Pensions, *Fact Sheet*, at http://www.thepensionservice.gov.uk/atoz/atozdetailed/stakeholder.asp#what (accessed 24 April 2007).

[43] UK Pension Regulator, 'Stakeholder Pensions', Financial Services Authority, *Fact Sheet*, 11 May 2005, at http://www.thepensionsregulator.gov.uk/stakeholderPensions/general/general-05.aspx#fsa (accessed 24 April 2007).

[44] Bernard H. Casey, 'Why People Don't Choose Private Pensions', *Discussion Paper* PI-0503, UK Pensions Institute, Cass Business School, City University, London, December 2004, p. 6.

Australia

71. In Australia, the relevant legislation and regulations allow a superannuation fund trustee to offer investment choice to fund members.[45] Australian superannuation funds are not required to offer investment choice to fund members; however one estimate suggests that 89 per cent of Australian superannuation funds do so. Across all regulated Australian funds the average number of investment choices is 23.[46] While the opportunity for member investment choice is widespread in Australia, few members actually make use of this opportunity, with most members choosing a fund's 'default' investment option.[47]

United Kingdom

72. In the UK investment choice in occupational pension schemes is described as being either common or very common.[48] The number of choices offered to members is between 4 and 10.[49] However, as with Australia, most members appear to opt for the default, or in UK terms 'lifestyle' investment option.[50]

United States

73. The situation is quite different in the US, where the investment in the most popular form of second tier retirement savings vehicles, the so called 401K funds can be controlled by the individual member. Member directed investment in these funds have increased sharply in

[45] S. 52(4) *Superannuation Industry (Supervision) Act 1993* and reg. 4.02 Superannuation Industry (Supervision) Regulations 1994, and APRA, *Superannuation Circular* No. II.D.1: 'Managing Investing and Investment Choice'. March 2006 at http://www.apra.gov.au/Superannuation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=10383 (accessed 15 August 2006).

[46] Paul Gerrans, Marilyn Clark-Murphy and Craig Speelman, 'Investment Choice through the Ages', *Paper presented at the 14th Colloquium of Superannuation Researches*, University of New South Wales, 20 July 2006, pp. 11-12.

[47] ibid.

[48] UK The Pension Regulator, The Occupational Pensions Schemes Regulatory Survey 2004: *Summary of Findings*, September 2005, p. 9, at http://www.thepensionsregulator.gov.uk/pdf/OPSsurveySummaryFindings.pdf (accessed 15 August 2006).

[49] M Scott Donald, Op. Cit.

[50] Institutional Investment in the United Kingdom: A Review (Myners Report), 6 March 2001, para 3.18 and 3.19, at http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf (accessed 15 August 2006) and Paula Hawkins, 'Retirement pot spoilt by choice', *The Times*, 20 May 2006.

recent years, however this is also a general trend amongst other types of retirement savings funds in the US.[51]

Comment

74. In Australia and the UK investment choice in retirement savings is restricted to the choice of a particular asset class or investment strategy offered by the schemes' trustees. In the US investment choice extends to the particular assets chosen by the member to be included in his or her individual account.

Responsibility of the trustee in member investment choice

Australia

75. Formally, superannuation fund trustees are required to ensure that each investment option meets the requirements of subparagraph 52(2)(f) of the SIS Act which requires the trustee to:

> (f) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:
>
> > (i) the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements;
> >
> > (ii) the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;
> >
> > (iii) the liquidity of the entity's investments having regard to its expected cash flow requirements;
> >
> > (iv) the ability of the entity to discharge its existing and prospective liabilities…

APRA requires this, and other prudential requirements, to be observed by trustees offering investment choice to their fund's members.[52]

[51] William E Evan and David Macpherson, *Participant Direction in Defined Contribution Plans*, July 2005, p. 2. This research was undertake on the behalf of the US Employees Benefit Security Administration and can be found at http://63.106.133.245/ebsa/publications/oprpapers.html#pension (accessed 15 August 2006).

[52] APRA, *Superannuation Circular* No. II.D.1: 'Managing Investing and Investment Choice', March 2006, para. 37 at p. 10.

76. One commentator has observed that this means that each particular investment choice must be a complete investment strategy. He went on to query how this requirement could be reconciled with a member's ability to invest some or all of their benefits in a single asset class that may be considered 'impudent' in the particular member's circumstances.[53] This commentator concludes that Australian superannuation trustees are potentially in a very difficult position when implementing investment choice in their funds.[54] This point was apparently confirmed in a recent decision by the Superannuation Complaints Tribunal where a member was successful in seeking compensation from a trustee in respect of the he member's investment in an investment option involving speculative stocks. This decision was later overturned by the Federal Court, but not for reasons that touched on a trustee's responsibility at this point.[55]

77. Under r.4.02 of the Superannuation Industry (Supervision) Regulations 1994 the trustee must give members the:

- investment objectives of each of the offered strategies;
- information the trustee reasonably believes necessary for the member, or the class of members, to understanding the effect of, and any risk involved in, each of those strategies; and
- range of directions that can be given to the trustees of their fund and the circumstances in which these directions can be changed.

78. Only when these requirements have been met in offering investment choice to members can a trustee rely on the protection in SIS Act s.55(5) against any action by members in relation to investment losses occasioned by their investment choice.

http://www.apra.gov.au/Superannuation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=10383 (accessed 16 August 2006)

[53] M Scott Donald, Op. Cit.

[54] This is not the view of the Australian Prudential Regulation Authority. At a recent conference an APRA representative informally noted that current law, regulation and APRA guidance gave sufficient protection to a superannuation trustees offering investment choice to their fund's members.

[55] *Perpetual Trustees Australia vs Wallace* [2007] FCA 527 (Federal Court, Edmonds J, 18 April 2007).

United Kingdom

79. Despite its prevalence in defined contribution plans there appears to be little in the way of legislative or regulatory backing for the UK trustee in offering investment choice to fund members.

80. The UK *Pensions Act 2004* requires both individual and corporate trustees to understand the principles of funding occupational pension schemes and the investment of assets of such schemes to the degree necessary to enable them to properly exercise the functions in question.[56] The UK Pension Regulator specifies, in one of its Codes of Practice documents, that these requirements include an understanding of the principles of investment choice.[57] Additional information on what is expected of trustees in relation to investment choice is available in the UK Scope of Guidance documents, but it does not go beyond the information in the Code of Practice.[58] It is likely that this particular document refers to a training course that all UK trustees must undertake to carry out their functions. Apart from declaring that this understanding is necessary for trustees of occupational pension funds there is no other information on what these principles or knowledge entail. UK trustees, if they have not undertaken the required training, are not even in a position to take responsibility for the exercise of member investment choice.

United States

81. In the US, the Department of Labour has issued 'Safe Harbour' regulations for defined contribution plans offering a choice of investments. The plan must offer at least three alternatives; each must be diversified and have different risk/return characteristics; the choices must allow participants to create a portfolio appropriate to that individual; and each combination must minimise the overall portfolio risk through diversification. Participants must be able to control their assets and be able to change their investment choices. There is also a requirement for the type of information that must be made available about these options.[59] The provision of the recent US *Pension Protection Act 2006* strengthens these requirements.[60]

[56] Sections 247 and 248, UK *Pension Act 2004*.

[57] The UK Pensions Regulator, Regulatory code of practice No. 7, 'Trustee Knowledge and Understanding' (TKU), p. 9, at http://www.thepensionsregulator.gov.uk/pdf/CodeTkuFinal.pdf (accessed 16 August 2006).

[58] The UK Pensions Regulator, 'Trustee Knowledge and Understanding, *Scope Guidance* (Defined contribution schemes with no link to defined benefit schemes)', Unit 5, at http://www.thepensionsregulator.gov.uk/pdf/scopeGuidanceDC.pdf (accessed 16 August 2006). As noted above, this particular document appears simply to refer to the training that a trustee must undertake.

[59] Myners Report, Op. Cit., p. 103 at http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf (accessed 16 August 2006. See also Staff of US Joint Committee on Taxation, TECHNICAL EXPLANATION OF H.R. 4, THE

82. Occupational retirement savings plans trustees or fiduciaries are protected from the liability to compensate fund members for consequences of that member's investment choice.[61] As in Australia, in order to claim this defence the US trustee or fiduciary must have regard to the requirements for diversification, risk and return.[62]

Comment

83. The UK's formal requirements for a trustee's ability to offer investment choice appear to be in advance of other countries requirements. However, Australia and the US may include such specific knowledge in their requirements for the licensing of superannuation fund trustees and fiduciaries respectively (see below).

The shift to defined contribution funds

84. Retirement savings schemes usually come in two main types – defined benefit and defined contribution. A defined benefit scheme is one where the final benefit is largely predetermined and calculated with reference to a member's final salary, and/or years of service. The final benefit does not mostly depend on the investment earnings of the fund. These schemes involve superannuation funds (and their employer/government sponsors) bearing the financial risk of adequately meeting member entitlements. A defined contribution fund is one where the end benefits are made up of the contributions to the fund plus investment earnings. In Australia, they are usually known as 'accumulation' funds. Because the final entitlement is dictated by market forces and contribution levels, these schemes shift the financial risk (i.e. whether a member's savings will be too little at retirement) from superannuation funds or the fund's sponsor to fund members.

85. Around the world the most significant development in retirement income has been the closure of many defined benefit funds and their replacement with defined contribution funds.[63] Demographic trends and reforms to pension systems towards the privatisation of

"PENSION PROTECTION ACT OF 2006," AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, p. 142 at http://www.house.gov/jct/x-38-06.pdf (accessed 17 August 2006) for good description of current US Dept of Labour regulations.

[60] ibid, p.222.

[61] US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, Part 4, §1104(2)(c)(1)(B) at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001104----000-.html (accessed 16 August 2006).

[62] M Scott Donald, Op. Cit.

[63] International Monetary Fund, *Global Financial Stability Report*, September 2005, p. 81.

pension savings, will most likely reinforce the creation of more and larger pools of investment capital that will be managed via defined contribution schemes.[64]

Australia

86. Currently only about 10 per cent of all fund members in are defined benefit schemes, nearly all these members are government employees.[65] The following table shows these changes.

Table 1: Changes in Superannuation Benefit Structure - September 2003 and June 2005

Benefit Type	Number of Funds 2004	Number of Funds 2006	Assets 2004 $ bn	Assets 2006 $ bn
Accumulation	290,659	327,214	388.7	511.9
Defined Benefit and Hybrid entities	529	299	180.3	356.3

Source: APRA Annual Superannuation Bulletin June 2004 & June 2006

87. What is driving the decline in the number of defined benefit funds? The *Superannuation Safety Amendment Act 2004* introduced several major requirements for superannuation trustees. These requirements are in addition to any licensing requirements required under the *Corporations Act 2001* for investment managers and providers of financial advice. Superannuation funds often also fulfil both these roles.

88. The new requirements are not without their cost in terms of time, resources and funding. One report suggests that superannuation trustees will have to pay a fee ranging from $3 500 to $20 000 to APRA to obtain a licence.[66] Additional costs arise from the ongoing compliance burden and the need to meet the capital requirements noted above.[67] One report notes that it has cost a major industry fund about $120 000 to comply with the requirements for an APRA licence.[68]

[64] ibid, p. 67.

[65] Australian Government, *A Plan to Simplify and Streamline Superannuation – Detailed Outline*, May 2006, p. 5.

[66] Alison Kahler, ‘Super licence will fry small fish’, *Australian Financial Review*, 23 August 2004, p. 51.

[67] The capital adequacy requirements for each entity will be determined on a case by case basis by APRA, but for many funds the required capital will be $5m per entity.

[68] Barrie Dunstan, ‘Choice will trim funds but not fees’, *Australian Financial Review*, 14 March 2005, p. 53.

89. In these circumstances the sponsors of corporate superannuation funds, many of which offered defined benefit schemes to their members, consider that the task of running a superannuation fund is best left to the experts and are outsourcing the administration of their fund to third parties (for example master trusts or retail trusts). Apparently, the new requirements for the licensing of superannuation trustees are the major reasons behind the reduction in the number of corporate superannuation funds.

90. A little recognised influence on a decision to outsource corporate superannuation may be the progressive adoption of the new international accounting standards, from 1 January 2005. Under these standards both surpluses and deficits in defined benefit superannuation funds run by companies are recognised either in the profit and loss statements for that company, against any retained earnings, or as an average charge against profits over time.[69] When financial markets are producing good returns and the defined benefit fund is in surplus this is not a problem. But during 2001/02–2002/03 financial markets did not produce good returns and many corporate defined benefit superannuation funds found themselves without enough assets to cover their liabilities. Their sponsoring companies had to make sometimes substantial contributions to their funds to cover the short fall in assets.[70]

91. Under the new accounting standards, unfunded deficits experienced by a company's defined benefit superannuation scheme are recognised in that company's financial accounts and may lead to a negative assessment of that company by financial markets. In extreme cases a company may enter either technical or actual insolvency due to its contributions to the fund. Over the longer term these factors provide a powerful incentive for companies to convert their defined benefit funds to accumulation funds and outsource their administration.

92. The decline in the number of Australian defined benefit funds is a long term trend. The introduction of superannuation fund trustee licensing and the new accounting standards are comparatively new factors. Other possible reasons for the decline in defined benefit funds in Australia may be:

- the recent trends in public finance has been to reduce long term liabilities. This may have led to the reduction in the number of public sector defined benefit schemes;

[69] Australian Accounting Standards Bord, *Accounting Standard AASB 119 – Employee Benefits*, pp. 7-8 at http://www.aasb.com.au/index.html (accessed 20 January 2005).

[70] John Stensholt and James Thomson, 'The super time-bomb', *Business Review Weekly*, 17-23 April 2003 pp. 14-16.

- corporate sponsors recognising that the provision of superannuation benefits is not part of their 'core' business – and that it is less trouble to outsource this part of their activities. Thus, the move away from corporate defined benefit schemes is part of modern corporate management practice;

- the introduction of Australian rules that immediately vest superannuation benefits in a member means that corporations cannot use the availability of superannuation benefits as a means of ensuring an employee's loyalty. Thus, corporate superannuation benefits have become far less important as a factor in a corporations' human resources strategies; and

- accumulation funds are relatively simple to operate and the size of the benefits is very easy for members to understand.

United Kingdom

93. Like Australia, the UK has experienced a rapid rise in the number of defined contribution schemes. In recent years there has been a significant shift in retirement income provision in the UK from the situation where employers offer defined benefit schemes, to a situation where defined contribution schemes are more common.[71] The following table from the UK Pensions Policy Institute shows the estimated number of defined contribution and defined benefit schemes in the UK in 2004.[72]

Table 2: Number of UK private sector occupational pension schemes by size and type (2004 estimates)[73]

Scheme size (total membership)	Defined Benefit	Defined Contribution	'Sectionalised'[74]	Total[75]
10,000+	129	7	58	194
5,000 – 9,999	129	26	56	211
1,000 - 4,999	694	55	360	1,109

[71] Alistair Byrne, Employee Saving and Investment Decisions in Defined Contribution Pension Plans: Survey Evidence from the UK', Pensions Institute Discussion Paper PI-0412, September 2004. p. 1.

[72] At http://www.pensionspolicyinstitute.org.uk/news.asp?p=165&s=8&a=0 (accessed 16 August 2006).

[73] GAD (2005) Occupation Pension Schemes 2004

[74] Sectionalised schemes are those where both defined contribution and defined benefit pensions are available

[75] Excludes schemes where type is unknown and public sector schemes.

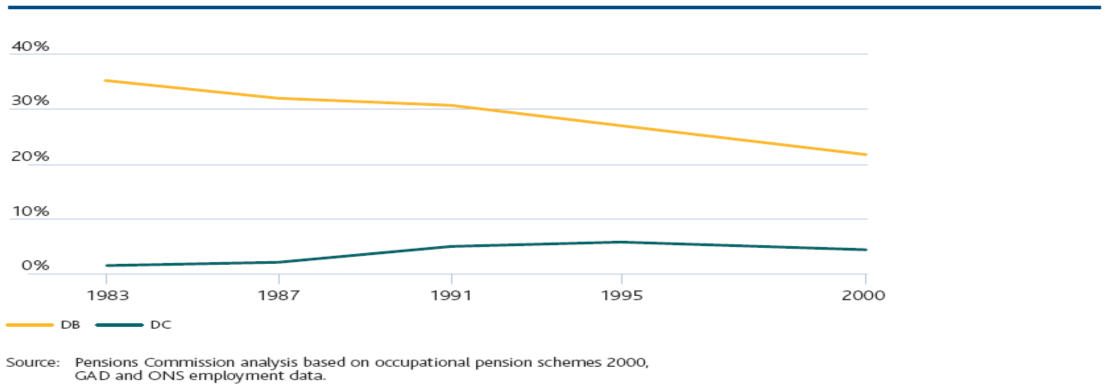
100 – 999	2,800	1,060	621	4,481
12 – 99	4,160	4,440	-	8,600
2 – 11	10,200	65,300	-	75,500
Total[76]	**18,100**	**70,900**	**1,095**	**90,095**

Source: UK Pension Policy Institute

As can be seen there are a large number of both defined contribution and defined benefit schemes with very few members. This may be due to the rise of small self administered pension funds in the UK and the large number of small defined benefit schemes that are now apparently being wound up (see below).

94. The following graph charts the long term decline in private sector defined benefit schemes in the UK.

Figure 2: Estimated Percentage of Private Sector employees participating in UK occupational pension schemes



Source: Pensions Commission analysis based on occupational pension schemes 2000, GAD and ONS employment data.

Source: UK Pension Commission First Report p. 82[77]

[76] Totals will not add up due to rounding.

[77] UK Pensions Commission, Pensions – Challengers and Choices: *The First Report of the Pensions Commission*, 2004, p. 82 at http://www.pensionscommission.org.uk/publications/2004/annrep/fullreport.pdf#search=%22UK%20Pensions%20Commission%22 (accessed 21 August 2006).

95. In 2004, the Pension Regulator's survey found that the most common pension offered to new employees of the main employer of the schemes surveyed was an occupational defined contribution scheme.[78]

96. The reasons for the increasing numbers of defined contribution schemes in the UK are complex. Part of the reason is the ability of employees to 'contract out' of the Government provided second tier pension in favour of private arrangements. As noted above, over 50 per cent of employees with second tier pension have chosen to 'contract out' of Government arrangements.[79]

97. Under the UK's 'contracting out' arrangements the employee and employer pay lower National Insurance (NI) contributions and the employee foregoes some Second State Pension benefits. Instead, the Government pays a rebate to a funded private pension scheme (either the occupational scheme of the employee or a personal pension). The scheme then has to pay benefits to replace the S2P benefit foregone, although there is no guarantee that they will be an equivalent amount. The size of the rebate is now set every 5 years by the Government Actuary, and can act as an incentive or disincentive to contract-out depending on whether the invested rebate is perceived to give more or less than the defined benefit under the Second State Pension.[80]

98. According to the UK Pension Regulator the driving force for the closure of defined benefit schemes has been the increasing recognition of the extent to which such schemes expose the sponsoring employer to non-business related, and in some cases uncontrollable, risks; particularly in relation to investment volatility and increasing longevity. Some key risks have materialised in recent years resulting in substantial scheme deficits.[81]

[78] UK The Pension Regulator, *The Occupational Pensions Schemes Regulatory Survey 2004*: Summary of Findings, September 2005, p. 1, at http://www.thepensionsregulator.gov.uk/pdf/OPSsurveySummaryFindings.pdf (accessed 16 August 2006).

[79] James Banks and Richard Blundell, 'Private Pension Arrangements and Retirement in Britain'. *Fiscal Studies,* Vo. 26, Nu. 1 (2005), pp 42 – 43. These authors note that about two thirds of employees have contracted out of the UK government second tier pension. However, recent evidence from the UK Pensions Commission suggests that currently less than 50 per cent of employees have non-government pension savings. see UK Pension Commission, Final Report, Implementing and integrated package of pension reforms, April 2006, p. 12 at http://www.pensionscommission.org.uk/publications/2006/final-report/final_report.pdf (accessed 22 August 2006).

[80] UK Pension Policy Institute: *The Pensions Primer Updated May 2006*, p. 6.

[81] The UK Pension Regulator, *Annual Report, 2005–06*, p. 9 at http://www.thepensionsregulator.gov.uk/pdf/AR20052006.pdf (accessed 17 August 2006).

99. Another reason for the rise of defined contribution schemes in the UK could be the recent instability of the UK retirement income system.[82] The ascendancy of defined contribution pension schemes has occurred against a backdrop of recurrent regulatory review and financial scandal. Since the collapse of the Maxwell company pension schemes in the early 1990s, trustees have seen two new Pension Acts in 1995 and 2004, changes in regulators (from Securities and Investments Board to Occupational Pension Regulatory Authority and now to the Pensions Regulator), three wide ranging parliamentary reviews (Goode, Myners and Pickering) several major financial scandals (including pensions mis-selling and the collapse of Equitable Life Group) and a major independent review of the retirement income system (Turner).[83] Individual defined contribution accounts could well be seen as being a much safer way to accumulate retirement savings than available alternatives in such an environment, but this conclusion is only speculative as the author is unaware of UK research on this point. Another view is that the severity of the requirements legislated in the recent UK *Pensions Act 2004* has led to employers winding up occupational defined benefits pension schemes and instituting accumulation style schemes in their place.[84]

100. However, the rate of decline in UK defined benefit schemes can be over-emphasised. Even with a continuation of the current rate of decline of active members in occupational defined benefit schemes, they will remain prominent for many years to come.[85]

United States

101. In the US traditional defined benefit pension plans covered 23 million individuals, about half of all private-sector workers in the United States, in 1960. But in the final years of the 20th century the trend reversed, and by 2006 the change was dramatic, with many employers either freezing or dropping their 'traditional' defined benefit pension plans. The following graph illustrates this trend.

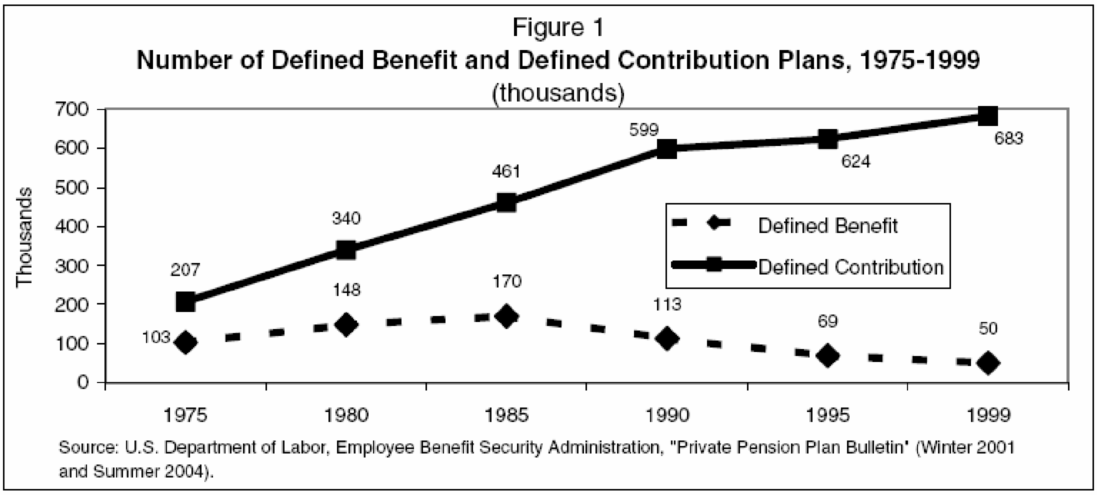
[82] For a good description of the causes of this instability see R. Kent Weaver, Op. Cit.

[83] M Scott Donald, Op. Cit.

[84] Debie Harrison, Alistair Byrne, Bill Rhodes & David Blake, *Pyhrric Victory? – the unintended consequences of the Pensions Act 2004,* The Pensions Institute, Cass Business School, City of London, October 2005.

[85] UK The Pension Regulator, Annual Report, 2005–06, p. 8.

Figure 3: US Defined Benefit and Defined Contribution Schemes



Source: US Employees Benefit Research Institute[86]

102. As noted previously, about half of all American private-sector workers are still offered a retirement plan at work, but among those who are, the "defined contribution" 401K-type of individual-account plan is now dominant. Such plans now have 47 million participants, more than four times as many as two decades ago. At the end of 2005, 401K plans held assets worth more than US$2.4 trillion.[87] The provisions for automatic enrolment of employees into a retirement savings plan in the US *Pension Protection Act 2006* will accelerate this trend.

103. The reasons behind the decline of defined benefit and the rise of defined contribution retirement plans in the US are complex. Amongst these reasons are:

- the vast majority of plan terminations have occurred among very small defined benefit plans, those with two to nine active employees. There is some suggestion that very small plans were used by employers as tax shelters. The decline in the number of such plans is thought to be the result of US federal legislation passed in the 1980's;

[86] US Employee Benefit Research Institute, 'The U.S. Retirement Income System', *Facts from EBRI*, April 2005, at http://www.ebri.org/pdf/publications/facts/0405fact.pdf (accessed 17 August 2006).

[87] US Employees Benefit Research Institute, The Employment Based Pension System: Evolution or Revolution?, *Notes*, Vol 27, No. 7, July 2006 at http://www.ebri.org/pdf/notespdf/EBRI_Notes_07-20061.pdf (accessed 17 August 2006).

- merger and acquisitions partially account for the decline in the number of defined benefit plans. When two firms offering defined benefit plans merge, the result is usually a single larger plan;[88]

- corporate America finds itself locked in global competition and has decided it can no longer afford, for competitive and cost reasons, to offer employees the same kind of retirement plans that many workers enjoyed in the past;

- *a fading "social compact":* The decline of traditional pensions and the rise of the 401(k) plan have left many workers wrestling with the realization that they have personal responsibility for their health and retirement planning and expenses. This shift is a move away from a long-standing "social compact" among workers, their employers, and the government. Some commentators have argued the change is the best result for most workers in a highly mobile work force, where relatively few workers stay at any one job long enough to qualify for traditional pensions;[89] and

- as the American workforce has grown so has the number of individual participants in employment based retirement plans. This would lead to rising number of defined contribution plans.

Funding arrangements for regulation

Australia

104. As noted above, the main agency regulating retirement savings in Australia is the Australian Prudential Regulation Authority (APRA). It is funded primarily through levies imposed on the industries it supervises. These levies, known as the Financial Institutions Supervisory Levies and are administered transactions collected on behalf of the Government and paid into the Consolidated Revenue Fund (CRF). An amount equal to the net levy revenue, less an amount specified by the Minister for Revenue and Assistant Treasure in an annual determination made under subsection 50(1) of the *Australian Prudential Regulation Authority Act 1998* (APRA Act), is payable to APRA as a Special Appropriation. The amounts specified in the Minister's determinations are retained in the CRF to cover the costs of providing market integrity and consumer protection functions for prudentially regulated institutions, functions that are conducted by other Australian Government entities.[90] The

[88] US Employee Benefit Research Institute, 'The U.S. Retirement Income System', *Facts from EBRI*, April 2005, at http://www.ebri.org/pdf/publications/facts/0405fact.pdf (accessed 17 August 2006).

[89] US Employees Benefit Research Institute, The Employment Based Pension System: Evolution or Revolution?, *Notes*, Vol 27, No. 7, July 2006 at http://www.ebri.org/pdf/notespdf/EBRI_Notes_07-20061.pdf (accessed 17 August 2006).

[90] Australian Prudential Regulation Authority, 2004–05 *Annual Report*, p. 69.

levies collected by APRA also cover some costs of the Australian Securities and Investments Commission and the Australian Taxation Office.[91]

105. In 2005 APRA collected $97.1m in supervisory levies from all financial institutions, of which $39.8m came from superannuation funds. In 2005 APRA's Special Appropriation was $77.2m. Of that amount $27.1m came from superannuation funds. Approximately $12.7m of the levy paid by superannuation funds was retained by government in the CRF.[92]

106. As at 30 June 2005 total superannuation assets regulated by APRA were $464.3 billion.[93] Taking all the above figures into account the Australian superannuation industry paid $39.8m in supervisory levies in 2005.[94] This is a fraction of one per cent of the assets under supervision (about 0.008%) and represents the total costs of supervision by all agencies. If only the supervisory levy amounts directly paid to APRA from superannuation funds are taken into account ($27.1m) the cost of supervision are less again (about 0.005% of assets under APRA supervision).

United Kingdom

107. In the UK the Pension Regulator is funded by grant-in-aid from the UK Department for Work and Pensions (DWP) and the running costs are recovered through the general levy on pension schemes. This levy imposed on schemes covers the cost of the Pensions Regulator, the Pensions Ombudsman and the Pensions Advisory Service.[95]

108. In respect of the period ending 31 March 2006 the UK Pensions Regulator had invoiced £31.4m in general supervisory levies.[96]

[91] ibid, p. 49

[92] ibid, Note 5 to the Accounts, p. 80.

[93] Australian Prudential Regulation Authority, Statistics: Annual Superannuation Bulletin, 20 April 2006, p. 5. Total superannuation assets are currently over $1tn. However, not all of those funds are directly regulated by APRA.

[94] Australian Prudential Regulation Authority, 2004–05 Annual Report, Note 5 to the Accounts, p. 80.

[95] The UK Pension Regulator, Annual Report, 2005–06, p. 3 at http://www.thepensionsregulator.gov.uk/pdf/AR20052006.pdf (accessed 17 August 2006).

[96] Op. Cit., p. 41. These are 'unaudited' figures, which is not too surprising given that the UK Pensions Regulator has recently commenced operation.

109. Reliable recent information on the value of pension scheme assets in the UK is not readily available. However the UK Pensions Regulator estimates that the assets of various occupational defined benefit pension schemes in 2005–06 is about £1 350 billion.[97] Using this figure, the general regulatory levy is about 0.002 per cent of the assets of the work place defined benefit schemes under supervision.

United States

110. The US Department of Labour, and its Employee Benefit Security Administration (EBSA), which supervises workplace retirement savings plans, is funded by direct appropriation from the overall US budget. The EBSA does not appear to apply a levy to funds under its supervision to recover its costs. The direct program costs for the supervision of the security of both employees' retirement savings and health benefits was US$299m in the 2001 financial year (latest available information).[98] It is not clear that this figure represents the final cost of all regulatory activity undertaken in relation to the supervision of US occupational retirement savings and so further analysis in comparison to the amount under the EBSA supervision is likely to be misleading.

Comment

111. Caution should be exercised in comparing the ratios of supervision costs to funds under supervision. The UK, with its greater population, has the advantage of economies of scale. Further, its workplace based savings system (albeit through defined benefit schemes of the most part) has been operating far longer than Australia's Superannuation Guarantee system. These factors alone would make cost comparisons between these countries misleading in respect of the efficiency or otherwise of APRA and the UK Pensions Regulator. Nor would such comparisons take into account the level of activity that each regulator undertakes. For example, the above discussion suggests that the EBSA undertakes far less regulatory activity than its Australian or US counterparts due to its non compulsory nature.

Presence of 'for-profit' or 'not-for-profit' retirement funds

What is a 'not for profit' retirement savings fund?

112. In the Australian context the Corporate Superannuation Association (the Association) has noted that in not-for-profit funds, the trustee body does not obtain profit, nor is there a

[97] The UK Pension Regulator, *Annual Report*, 2005–06, p. 9.

[98] US Department of Labour, *Annual Report 2001* (latest available), p.58 at http://www.dol.gov/_sec/media/reports/annual2001/goal2.pdf (accessed 19 August 2006).

dividend payable to shareholders of the trustee bodies. The main reason for the existence of the funds is a concern on the part of the employer sponsor to provide for the welfare of employees and their dependants through appropriate incentive and benefit structures. There is no profit motive or commercial interest in bringing funds under management. The governing trustee bodies represent the interests of members and sponsoring employers.

113. In contrast, the Association notes that 'for profit' superannuation entities may be:

- superannuation funds, master trusts, pooled superannuation trusts or unit trusts;
- fund administrators, investment managers, or professional trustees; and
- any combination of the above.

114. The prime characteristic of for-profit funds is the offering and issuing of financial products in order primarily to realise profit for the issuer's shareholders. These service providers and their agents have a financial interest in drawing additional funds under management. They have no connection, other than commercial, with either the sponsor or the members.[99]

Alternative View

115. A prominent superannuation commentator, Mr Alex Dunnin, has argued that the classification of superannuation funds into 'for-profit' and 'not-for-profit' can be misleading, as this quote from a 2004 conference paper argues.

> Industry funds also often describe themselves as "not-for-profit". This means, in theory, their fees match their costs as they don't need to make a profit for any shareholders. On the other hand, master trusts because they are commercial funds, must try to make a profit and so they have to charge fees that are more than their costs. But does being not for profit make a fund better, or does it just make it different?
>
> At Rainmaker we suggest the best way to answer this question is by reminding yourself what a super fund fundamentally is, i.e. it is a savings fund that you contribute to through your working life so that by the time you retire will have saved enough money to retire at

[99] Corporate Superannuation Association, Submission, Senate Select Committee on Superannuation, *Inquiry in Superannuation and Standards of Living in Retirement: tax arrangements for superannuation and related policy*, 2002, p. 3, at http://www.aph.gov.au/Senate/committee/superannuation_ctte/completed_inquiries/2002-04/living_standards/Submissions/sub041.doc (accessed 18 August 2006).

> least gracefully. The paradigm of being for-profit or not-for-profit is therefore only a description of a super fund's business ethos. It is not a statement of its effectiveness. Indeed, if the not-for-profit issue was paramount then such funds would not themselves invest to make profits and they would not use the services of profit making service providers.
>
> In any case, it is really a misnomer to call such funds not-for-profit as in reality it is the trustee company operating the fund that is not-for-profit rather than the fund itself. Reflecting this, Rainmaker strongly argues that super funds should be judged on their features and what they deliver to their consumers. Business ethos questions, while helpful to understand a super fund's background, do not in themselves shed light on the quality or effectiveness of the super fund as a product or whether it meets its members' wealth management needs.[100]

Comment

116. The Association's view focuses on the role of the employer sponsor. However, this focus excludes the now significant SMSF (and like overseas funds) from classification as 'not-for-profit' arrangements. Clearly such funds should not be excluded from this group.

117. While Mr Dunnin's focus on the suitability of a particular superannuation fund to the overall needs of a member is helpful in focusing on choosing the most appropriate fund, it is not that helpful in determining the prevalence of such funds in the retirement income systems under consideration.

118. The Australian Accounting Standards Board defines a 'not-for-profit' entity as:

> an entity whose principal objective is not the generation of profit. A not-for-profit entity can be a single entity or a group of entities comprising the parent entity and each of the entities that it controls.[101]

This is an extremely broad definition when applied in the superannuation environment.

[100] Alex Dunnin, Director Research, Rainmaker Information Pty Ltd, 'A framework for distinguishing between Super Funds', *Paper presented to the 2004 Australian 12th Colloquium of Superannuation Researchers*, University of New South Wales, July 2004 at http://wwwdocs.fce.unsw.edu.au/fce/Research/ResearchMicrosites/CPS/Dunin.pdf#search=%22superannuation%20not%20for%20profit%22 (accessed 18 August 2006).

[101] Australian Accounting Standards Board, *Accounting Standard AASB 102*, 'Inventories', July 2004, paragraph Aus6.1, p. 12 at http://www.aasb.com.au/ (accessed 18 August 2006).

Australia

119. Taking this broad definition as a starting point, in Australia, 'not-for-profit' superannuation funds would include:

- corporate;
- industry;
- public sector; and
- small funds (including SMSF and small APRA funds).

120. The following table illustrates the current prevalence of such funds.

Table 3: Australian Non Profit Superannuation Funds - December 2006

Fund Type	Assets $bn	No. of Entities	% of Overall Total Assets	% of Overall Total Entities
Corporate	67.7	386	6.7%	0.11%
Industry	172.1	75	17.3%	0.02%
Public Sector	157.8	42	15.6%	0.01%
Small	237.7	338,063	23.5%	99.7%
Total Non Profit	889.7	338,566	**88.0%**	**99.8%**

Source: APRA[102]

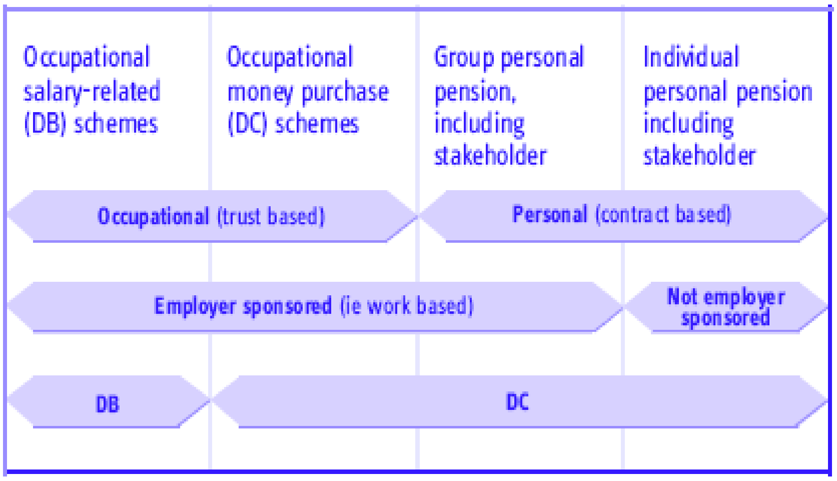
121. At the end of the December Quarter 2006 the total superannuation assets were $1010.7bn managed by 338,850 separate funds (the overwhelming proportion of those funds were small APRA funds or SMSFs). This resulted in 88 per cent of assets and 99.7 per cent of funds falling into the non profit category.

[102] Australian Prudential Regulation Authority, *Statistics*, *Quarterly Superannuation Performance*, Key statistics Superannuation industry quarterly estimates, December 2006 (issued 29 March 2007), p. 7

United Kingdom

122. The following diagram gives a detailed picture of forms in which UK retirement savings are held.

Figure 4: UK Retirement Savings


Occupational salary-related (DB) schemes
Occupational money purchase (DC) schemes
Group personal pension, including stakeholder
Individual personal pension including stakeholder
Occupational (trust based)
Personal (contract based)
Employer sponsored (ie work based)
Not employer sponsored
DB
DC

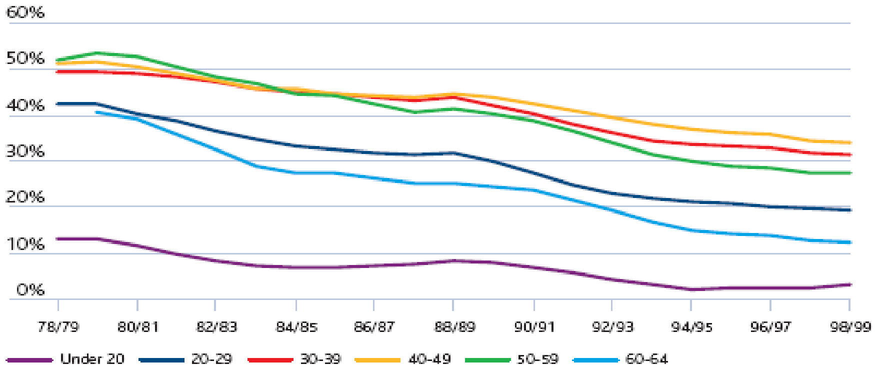
Source: UK Pensions Regulator[103]

123. In the above diagram the occupational, employer sponsored schemes are likely to fall into the 'not for profit' category, while the personal (contracted out) and not employer sponsored schemes are likely to be in the 'for profit category'.

124. Exact figures on the proportion of 'contracted out' or personal pension plans are not readily available. However, the following graph indicates that the numbers of male participants in such arrangements is declining across all ages.

[103] The UK Pension Regulator, Annual Report, 2005–06, p. 7 at http://www.thepensionsregulator.gov.uk/pdf/AR20052006.pdf (accessed 18 August 2006). Based on Table 3.3, Types of Private Pension Provision, UK Pensions Commission, Pensions – Challengers and Choices: The First Report of the Pensions Commission, (Turner) 2004, p. 80 at http://www.pensionscommission.org.uk/publications/2004/annrep/fullreport.pdf#search=%22UK%20Pensions%20Commission%22 (accessed 21 August 2006).

Figure 5: Percentage of Men in Contracted-out Salary Related Schemes, by Age, In the UK

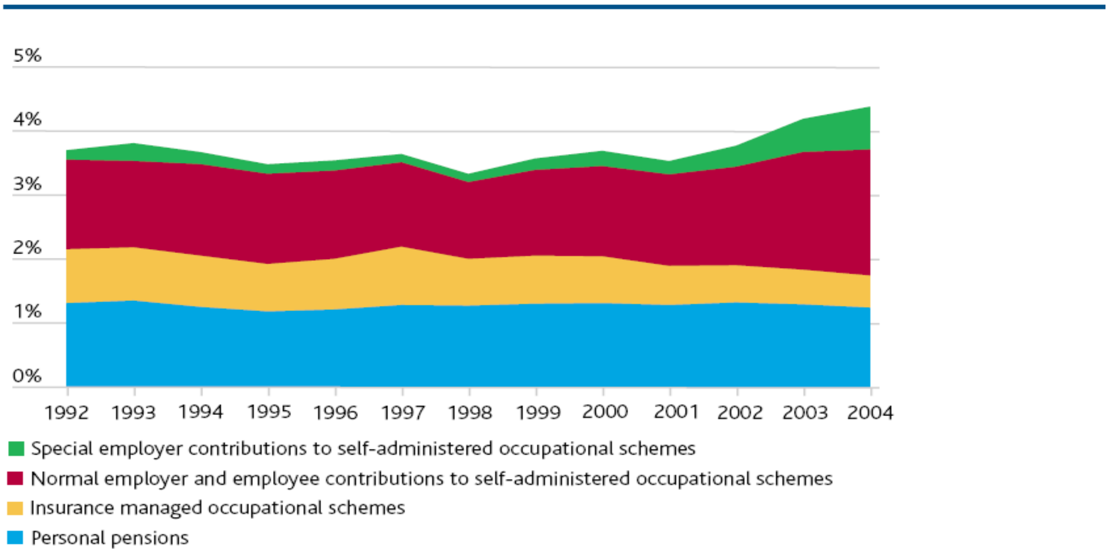


Source: UK Pensions Commission, First Report, 2004.[104]

125. If the proportion of employees in the ‘contracted out’ savings schemes is declining, this is consistent with the notion that the number of participants in ‘for-profit’ retirement savings arrangements are also declining. The implication of these trends is that ‘not-for-profit’ schemes are of increasing importance in the UK. This impression is confirmed by the following breakdown of contributions to funded pension arrangements in the UK.

[104] UK Pensions Commission, Pensions – Challengers and Choices: The First Report of the Pensions Commission, 2004, p. 82 at http://www.pensionscommission.org.uk/publications/2004/annrep/fullreport.pdf#search=%22UK%20Pensions%20Commission%22 (accessed 21 August 2006).

Figure 6: Components of Funded Pension Contributions as a Percentage of GDP in the UK



Source: UK Pensions Commission, Second Report[105]

126. In the above graph the 'special employer contributions to self administered schemes' and the 'normal employer and employee contributions to self administered occupational schemes' are clearly contributions to 'not-for-profit' schemes. The contributions to these schemes have risen over the period covered by this graph. The contributions to 'insurance managed occupational schemes' represents contributions to 'for-profit' arrangements. The contributions to 'personal pensions' may be 'for profit' arrangements, though the text of the source does not address this question. In any event, these contributions have declined slightly over the period covered by the graph. Overall this graph suggests that contributions to 'not for profit' schemes in the UK are rising as a proportion of overall total contributions.

United States

127. Retirement savings in the US is undertaken through a variety of tax advantaged savings vehicles:

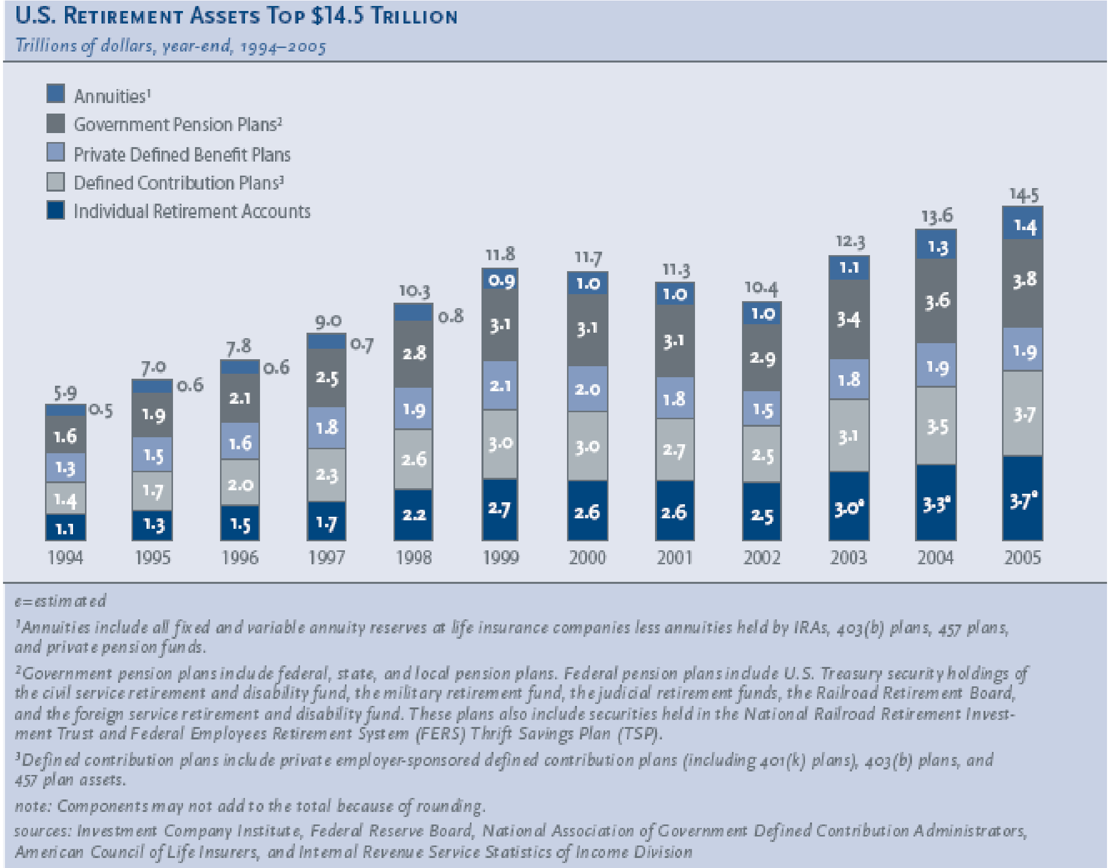
- traditional individual retirement accounts (IRAs);
- 401K, 403B & 457 plans (sections of the US Income Tax Code);

[105] UK Pensions Commission, Second Report, *A New Pensions Settlement for the Twenty First Century*, 30 November 2005, Chapter 1, p. 56 at http://www.pensionscommission.org.uk/publications/2005/annrep/annrep-index.asp (accessed 21 August 2006).

- the Federal Employees' Thrift Savings Plan;
- salary reduction simplified employee pension (SAR-SEP) plans; and
- savings incentive match plans for employees of small employers (SIMPLE).[106]

128. A number of these account types, such as the 401K are employer sponsored funds. SEP, SAR-SEP, and SIMPLE IRAs—despite being labelled "individual accounts"—are, in fact, employer-sponsored savings vehicles.[107] They would be equivalent to corporate sponsored superannuation funds in Australia and thus are firmly in the 'not-for-profit' category. The following graph shows the recent makeup of retirement savings in the US.

Figure 7: Composition of US Retirement Savings



U.S. RETIREMENT ASSETS TOP $14.5 TRILLION

Trillions of dollars, year-end, 1994–2005

e=estimated

[1] Annuities include all fixed and variable annuity reserves at life insurance companies less annuities held by IRAs, 403(b) plans, 457 plans, and private pension funds.

[2] Government pension plans include federal, state, and local pension plans. Federal pension plans include U.S. Treasury security holdings of the civil service retirement and disability fund, the military retirement fund, the judicial retirement funds, the Railroad Retirement Board, and the foreign service retirement and disability fund. These plans also include securities held in the National Railroad Retirement Investment Trust and Federal Employees Retirement System (FERS) Thrift Savings Plan (TSP).

[3] Defined contribution plans include private employer-sponsored defined contribution plans (including 401(k) plans), 403(b) plans, and 457 plan assets.

note: Components may not add to the total because of rounding.

sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

[106] James R Story, Retirement Plans with Individual Accounts: Federal Rules and Limits, Congressional Research Service, *Report for (US) Congress*, 27 February 2003

[107] Peter Brady and Sarah Holden, The US Retirement Market 2005, *The (US) Investment Company Institute, Research Fundamentals*, Vol. 15 Nu. 5, July 2006, p. 5 at http://www.ici.org/home/fm-v15n5.pdf (accessed 22 August 2005).

Source: (US) Investment Company Institute[108]

129. In the above graph the defined contribution plans, private defined benefit plans and individual retirement accounts would be classed as 'not-for-profit' arrangements. In 2005, collectively, these arrangements accounted for about 64 per cent of total US retirement savings.

Double Superannuation Coverage

130. 'Double superannuation coverage' occurs when an employee is sent to work temporarily in another country and the employer or employee (or both!) are required to pay superannuation (or equivalent) contributions under the legislation of both countries for the same work. Such arrangements are likely to be increasingly important as international labour mobility increases.

Australia

131. In Australia, this issue is addressed through the need to pay the Superannuation Guarantee payments on behalf of both employees posted temporarily to another country, and on behalf of those working temporarily in Australia.

132. Australia has entered into international agreements with a number of countries which address the issue of 'double superannuation coverage'. The agreements on double superannuation coverage form part of broader international agreements on social security between Australia and a number of other countries. Australia currently has agreements covering double superannuation coverage with the following countries:

- the Kingdom of Belgium;
- the Republic of Croatia;
- the Republic of Chile;
- the Kingdom of The Netherlands;
- the Republic of Portugal;
- the United States of America;
- the Republic of Ireland; and

[108] Op. Cit., p. 2.

- the Kingdom of Norway.

133. Under the agreements, employers are exempted from the need to pay superannuation (or equivalent) contributions in the country to which their employee has been temporarily sent, provided they, or their employee (if necessary), pay compulsory Superannuation Guarantee contributions.

134. Generally, where an Australian employee is working for an Australian employer overseas, they will remain subject to the superannuation guarantee legislation, and the Australian employer is required to pay ongoing superannuation contributions.

135. An employee sent to work temporarily in Australia would be exempted from Australia's superannuation guarantee legislation, as they and their employer would pay contributions solely under the arrangements current in their country of origin, if that country was party to a double superannuation agreement with Australia.[109]

136. Superannuation Guarantee payments are not required to be made for some foreign executives who hold certain visas or entry permits under the migration regulations.[110]

137. In other cases, if a person is working temporarily in Australia, their employer is required to pay the required level of Superannuation Guarantee payments on their behalf, even if that person continues to contribute to their country of origin's retirement savings system. However, when they leave Australia they may be able to access these amounts under the 'Departing Australia Superannuation Scheme'.

United Kingdom

138. In the United Kingdom the recognition of contributions made to overseas pension schemes on the behalf of those working in the country temporarily comes about through the tax deductibility of contributions made to certain overseas pension funds.

139. Contributions made to 'Qualifying Recognised Overseas Pension Schemes' (QROPS) on behalf of a relevant migrant member of such schemes in the UK are tax deductible to that

[109] Australian Taxation Office, *Superannuation Guarantee – A guide for employers*, at http://www.ato.gov.au/superprofessionals/content.asp?doc=/content/19818.htm&page=54&pc=001/006/018/015/001&mnu=30413&mfp=001/006&st=&cy=1 (accessed 20 March 2007).

[110] S.27(1)(d) *Superannuation Guarantee (Administration) Act 1993*, list of relevant visas can be found in regulation 7(1) Superannuation guarantee (Administration) Regulations 1994.

employer.[111] A 'relevant migrant member' is a person who was a member of such a scheme before they became a tax resident of the UK as well as having to meet a number of other conditions.[112] A QROPS is one that has notified UK Revenue and Customs that it is an overseas pension scheme and, if required, have provided supporting documentation. If documentation is required UK Revenue and Customs would normally ask for a copy of the letter of tax approval or a letter from the tax authority confirming that status. But if the country in which the scheme is established does not have a system of tax approval then a letter from the tax authority confirming that the scheme is resident there and a copy of the scheme's rules may be required instead.[113] There is an extensive list of QRPS, which include large Australian corporate, industry, retail and government superannuation funds.[114]

140. Tax relief is also provided to an employer who makes contributions to a foreign, non-EU, pension scheme on behalf of a UK resident employee, but only where:

- the UK and the country where the pension scheme is located have a double tax agreement in force;
- a provision of that agreement grants such relief; and
- the scheme into which the contributions are made generally corresponds to the type of scheme qualifying for such approvals in the particular agreement.[115]

[111] HM Revenue and Customs, Registered Pension Schemes Manual 13101030 Technical Pages: International: Migrant member relief: Relief for employers at http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM13101030.htm (accessed 22 March 2007).

[112] HM Revenue and Customs, Registered Pension Schemes Manual 13101040 Technical Pages: International: Migrant member relief: definition of relevant migrant member, at http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM13101040.htm (accessed 22 March 2007).

[113] HM Revenue and Customs, Registered Pension Schemes Manual 13101060 Technical Pages; International Migrant member relief: Definition of qualifying overseas pension scheme at http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM13101060.htm (accessed 22 March 2007).

[114] HM Revenue and Customs, List of QROPS at http://www.hmrc.gov.uk/pensionschemes/qrops.pdf (accessed 22 March 2007).

[115] See HM Revenue and Customs, DT19876B United States of America Pension Contributions, 2003 at http://search.hmrc.gov.uk/kbroker/inldrev/inldrev/search.lsim?sr=0&nh=20&cs=iso-8859-1&sc=ir&ha=7&mt=0&qt=pension+contributions (accessed 22 March 2007), and DT17359 Particular Agreements: South Africa: Pension Contributions at http://www.hmrc.gov.uk/manuals/dtmanual/DT17359.htm (accessed 22 March 2007) and DT4858 Chile – Pensions and Pension contributions at http://www.hmrc.gov.uk/manuals/dtmanual/dt4858.htm (accessed 22 March 2007).

United States

141. The important point for employer contributions to foreign pension funds iswhether those contributions are tax deductible when they are made. Generally, US employer contributions to foreign pension funds are not tax deductible without the coverage of a tax treaty with another country.

142. The United States generally taxes the worldwide income of U.S. expatriates, including employer contributions to foreign pension plans. Without an overriding tax treaty provision with the country where the U.S. expatriate is working the benefit, accruals or employer contributions under a foreign plan become U.S. taxable income when the employee's benefits vest (i.e. become the property of the employee). Since foreign plans generally cannot or do not satisfy U.S. qualification requirements, they are treated as nonqualified plans, with accruals often taxed long before distribution. However, if a tax treaty is in place, and contains the appropriate provisions, accruals, contributions and income in either U.S.-qualified plans or a foreign country's approved schemes, will be taxed when amounts are distributed, not when they are earned.[116]

143. If compliance with US *Employee Retirement Income Security Act 1974* in foreign country by a US controlled company would violate that countries law then the provisions of the EBSA do not apply to that US employer.[117]

Comment

144. Arrangements for the recognition of another countries retirement income system appear to depend on the provisions of any bilateral tax or social security treaties. Outside the provisions of these treaties neither Australia, the UK or the US take account of another countries retirement arrangements in their tax, social security or retirement income systems.

[116] Source: Watson Wyatt International Pension Consultants.

[117] US Code, Title 38, Part III, Chapter 43, Subchapter II, §4319(d), at http://www4.law.cornell.edu/uscode/html/uscode38/usc_sec_38_00004319----000-.html (accessed 22 March 2007).

Section 4: Safety of Savings

145. Ensuring the safety of retirement savings is a fundamental task of any pension or superannuation regulatory regime. The following section briefly examines the more important arrangements under a number of areas related to the safety of retirement savings. The following discussion is by no means a complete survey of each country's arrangements to ensure the safety of their retirement savings.

Compensation for theft and fraud, plan sponsor insolvency or withdrawal of sponsorship

146. This section describes the current arrangements for compensating fund members in the event that their retirement savings are stolen or pension plan sponsor becomes insolvent or withdraws sponsorship from the scheme.

Australia

147. Part 23 of the SIS Act contains provisions for granting financial assistance to regulated superannuation funds and Approved Deposit Funds (ADFs) that suffer losses through theft or fraud. Under SIS Act Pt 23 (sections 227 to 240), a regulated superannuation fund or an ADF may apply to the Treasurer for a grant of financial assistance (SIS Act s 229).

148. The *Superannuation (Financial Assistance Funding*) *Levy Act 1993* (Funding Act) imposes a levy on regulated superannuation funds and ADFs for the purpose of funding the financial assistance provided under SIS Act Pt 23. The provisions of the *Financial Institutions Supervisory Collection Act 1988* (Collection Act) also applies to the operation of the Funding Act and the SIS Act in respect of this particular levy.

Regulations

149. Each year, a set of regulations is made setting out the prescribed levy for that year. For example, the Superannuation (Financial Assistance Funding) Levy and Collection Amendment Regulations 2006 (No. 1) (SLI 2006 No. 104) imposes a levy sufficient to recoup financial assistance granted in 2004–05 of about $3.2m.[118]

[118] The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, 'Explanatory Statement, Select Legislative Instrument 2006 No. 104', Superannuation (Financial Assistance Funding) Levy and Collection Amendment Regulations 2006 (No. 1), p. 1.

What Funds are Covered?

150. SIS Act s. 288 defines the term ‘fund’ for the purposes of SIS Act Pt 23 to mean ‘a regulated superannuation fund or an approved deposit fund but does not include a self managed superannuation fund.’ This definition is repeated in s.5 of the Funding Act. Thus a fund, for the purposes of SIS Act Pt 23, does not include an SMSF. Section 6 of the Funding Act also exempts from the levy in a particular financial year those funds to whom a grant of financial assistance has been made in that financial year. That is, if a grant of assistance was made in the 2004–05 year, the fund in question would not be subject to the levy in the 2004–05 year.

How is the levy calculated?

151. Section 7 of the Funding Act prescribes that the value of the levy is determined by the amount of revenue to be raised to meet the costs of making grants of financial assistance to funds. However, subsection 7(2) of the Funding Act provides that the total sum of the levy (or levies where two or more separate levies are applied during the same financial year) cannot exceed 0.05 per cent of a fund’s assets at the end of the previous financial year.

152. In practice, each yearly set of regulations precisely defines the maximum and minium amounts and the applicable rate mentioned in this section. The following table gives these factors as they have applied in previous years.

Table 4: Table of Levy Amounts - Australia

	2001/02	**2001/02***	**2002/03**	**2003/04**	**2004/05**
Levy rate	0.000083%	0.000022%	0.00025%	0.000046%	0.0000085%
Maximum levy	$33,000	$20,000	$85,000	$30,000	$35,000
Minimum levy	$100	$10	$100	$100	$120

Source: CCH Master Superannuation Guide – 2005–06 topic 3-930 and Superannuation (Financial Assistance Funding) Levy and Collection Amendment Regulations 2006 (No. 1)

Note: * An additional levy for the outstanding shortfall in levy collections not recouped in the first 2001/02 levy.

153. As can be seen, this particular levy is a very small percentage of a fund's assets, and is in any event, capped. Thus the compensation provided by this levy is potentially limited.

154. In addition, under sections 215 to 218 of the SIS Act where an individual has been subject to either a civil or criminal offence, and as a result a superannuation trust has suffered loss, orders can be made to recover some or all of that loss from that individual.

United Kingdom

155. In the UK the Pension Protection Fund has been designed to pay compensation to members of eligible defined benefit occupational pension schemes and the defined benefit elements of hybrid schemes, when there is a qualifying insolvency event in relation to the employer on or after 6 April 2005 with no possibility of a scheme rescue, and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.[119]

156. It is not clear whether a 'qualifying insolvency event' for the purposes of the UK Pension Protection Fund includes the misappropriation of a fund's money through theft or fraud. However, the Pension Protection Fund took responsibility for the former UK Fraud Compensation Fund, which provided compensation to occupational pension funds in the event that they suffered loss due to dishonesty (see below). If an individual, company or partnership enters insolvency, for any reason after 6 April 2006, then the provisions in the UK *Pension Act 2004* relating to the Pension Protection Fund are triggered.[120]

Coverage

157. Not all UK retirement savings schemes are covered by the Pension Protection Fund. It is limited to workplace based defined benefit schemes. Defined contribution schemes are not covered by this scheme.

Level of Compensation

158. Broadly speaking the Pension Protection Fund will provide two levels of compensation. For individuals that have reached their scheme's normal pension age or, irrespective of age,

[119] UK the Pension Protection Fund, A Guide to the Pension Protection Fund Levies 2005/06, p. 2 at http://www.pensionprotectionfund.gov.uk/guide_to_levies.pdf (accessed 22 August 2006).

[120] S.121 UK *Pension Act 2004* and Regulation 5 of the UK Pension Protection Fund (Entry Rules) Regulations 2005.

are either in receipt of survivors' pension or a pension on the grounds of ill health, the Pension Protection Fund will pay 100% level of compensation. There may be limits on the rate at which on-going payments are indexed. In broad terms, this means a starting level of compensation that could equate to 100% of the pension in payment immediately before the assessment date (subject to a review of the rules of the scheme by the Pension Protection Fund).

159. For the majority of people below their scheme's normal pension age the Pension Protection Fund will pay 90% level of compensation. Again, there are limits on the rate at which on-going payments are indexed. In broad terms and in normal circumstances, this means 90% of the pension an individual had accrued immediately before the assessment date (subject to a review of the rules of the scheme by the Pension Protection Fund). This compensation is subject to an overall cap which equates to £26,050 at age 65 (the cap will be adjusted according to the age at which compensation comes into payment).[121]

160. However encouraging this level of cover may sound, a recent case suggests that in practice the level of compensation received may be far lower for schemes that became insolvent before 2004. A recent decision by the European Court of Justice noted that the compensation paid to former members of the UK Allied Steel and Wire pension scheme was inadequate and EU insolvency directives were breached. Briefly, some former members of this scheme received 20 per cent of their expected benefits when Allied Steel and Wire went in to liquidation.[122] To be fair, this particular scheme may have collapsed before the UK Pension Protection Fund came into operation (2004). Press reports indicate that the UK government will now fully compensate those who have not received adequate compensation for their losses due to scheme collapses between 1997 and 2004.[123]

[121] The (UK) Pension Protection Fund, *An Introductory Guide to the Pension Protection Fund*, p. 5, at http://www.pensionprotectionfund.gov.uk/420054_ppf_leaflet_v10a.pdf (accessed 22 August 2006).

[122] 'Court rules that UK government failed to protect pension funds', *European Pension & Investment News*, 12 February 2007, at http://www.epn-magazine.com/news/fullstory.php/aid/2584/Court_rules_that_UK_government_failed_to_protect_pension_funds_.html (accessed 29 March 2007).

[123] Justin Harper, 'Does the Pension Fix add up?', UK *Daily Mail*, 28 March 2007 at http://www.thisismoney.co.uk/retirement/article.html?in_article_id=418875&in_page_id=6 (accessed 29 March 2007).

Funding

161. The UK Pension Protection Fund is financed by a levy on all occupational defined benefit funds covered by the scheme. For the period ending 31 March 2006 the total Pension Protection Fund Levy invoice was £31.6m.[124]

162. The scheme has recently commenced operation and it is too early to tell whether it may experience the kind of problems that plague a similar US scheme. However, substantial negative comment about the scheme has been made.[125]

Fraud Compensation

163. Payments come from the UK Fraud Compensation Fund are financed by a separate Fraud Compensation Levy.[126] The Board of the UK Pension Protection Fund administers these provisions.[127] It applies to most defined benefit and defined contribution occupational pension schemes – apart from those specifically excluded in the *Pensions Act 2004*. It does not apply to state retirement pensions.[128]

164. As a general rule the amount of compensation due will be the difference between i & ii as follows:

- (i) the value of the assets as stated in the audited scheme accounts, or the Pension Protection Fund valuation, which immediately precede the loss, or if neither of these exist, the value of the assets on the date immediately preceding the loss as reported by an accountant – adjusted to take account of any alterations in their value between the date immediately preceding the loss and the application date; and

[124] The UK Pension Regulator, *Annual Report, 2005–06*, p. 41 at http://www.thepensionsregulator.gov.uk/pdf/AR20052006.pdf (accessed 22 August 2006).

[125] OECD, Directorate for Financial and Enterprise Affairs, *Benefit Security Pension Guarantee Schemes*, 10 July 2006, pp. 20 – 23. at http://www.oecd.org/dataoecd/9/28/37084473.pdf (accessed 25 August 2006).

[126] Sections 182 to 189 UK *Pension Protection Act 2004*.

[127] S. 110 ibid.

[128] UK Pension Protection Fund, *Fraud Compensation Fund* at http://www.pensionprotectionfund.org.uk/index/main-functions/fraud_compensation_fund.htm (accessed 23 August 2006).

- (ii) the value of the assets immediately before the application date as reported by an accountant.[129]
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United States

165. As noted above, trustees or fiduciaries of US workplace based retirement savings plans have to post a bond of between US$1000 and $500 000 (or more if determined by US Secretary of Labour) but in any case not more than 10 per cent of the amount of funds handled. The purpose of this bond is to compensate for the effects of theft or fraud on the part of the fiduciary.

166. In the US occupational defined benefit pension schemes are protected by the operation of the Pension Benefits Guaranty Corporation (PBGC). This body was created by the *Employee Retirement Income Security Act of 1974* to encourage the growth of defined benefit pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at a minimum.[130] It is not clear that the PBGC has a formal role in paying pension if a scheme is affected by theft or fraud. However, if a US pension scheme finds itself in a position of not being able to pay pensions because of dishonesty then the PBGC may well become involved. As noted below, the PBGC faces long term financial difficulties.

Coverage

167. The program insures only private-sector defined benefit plans; it does not insure church or public sector pension plans, nor does it insure defined contribution plans (such as 401K plans).[131]

Level of Compensation

168. The maximum pension benefit guaranteed by PBGC is set by law and adjusted yearly. For single-employer plans ended in 2006, workers who retire at age 65 can receive up to US$3,971.51 a month (or US$47,659.08 a year). The guarantee is lower for those who retire

[129] Op. Cit.

[130] US Pension Benefits Guaranty Corporation (PBGC), Mission and Background, *Fact Sheet*, at http://www.pbgc.gov/media/key-resources-for-the-press/content/page13540.html (accessed 23 August 2006).

[131] Employee Benefits Research Institute, Basics of the Pension Benefit Guaranty Corporation, *Facts from EBRI*, July 2005 at http://www.ebri.org/pdf/0705fact.pdf (accessed 23 August 2005).

early or when there is a benefit for a survivor. The guarantee is increased for those who retire after age 65.[132]

Funding

169. PBGC is not funded by general tax revenues. PBGC collects insurance premiums from employers that sponsor insured pension plans, earns money from investments and receives funds from pension plans it takes over.

170. Pension plans pay PBGC yearly insurance premiums: US$8 per worker or retiree in multiemployer plans; US$30 per worker or retiree plus US$9 for each US$1000 of unfunded vested benefits in single-employer plans. Premium rates increase only if Congress approves.[133]

Pension Benefits Guaranty Corporation Problems

171. The PBGC scheme is facing a number of problems:

- the current premium structure does not properly reflect risks to the insurance program. The current premium structure relies heavily on flat-rate premiums that, since they are unrelated to risk, result in large cost shifting from financially troubled companies with under-funded plans to healthy companies with well-funded plans;
- PBGC also charges plan sponsors a variable-rate premium based on the plan's level of under-funding. However, these premiums do not consider other relevant risk factors, such as the economic strength of the sponsor, plan asset investment strategies, the plan's benefit structure, or the plan's demographic profile;
- the scheme faces market risk that a poor economy may lead to widespread under-funded terminations during the same period, potentially causing very large losses;
- PBGC may face risk from insuring plans concentrated in vulnerable industries affected by certain macroeconomic forces such as deregulation and globalization that have played a role in multiple bankruptcies over a short time period, as happened in the US airline and steel industries;

[132] US PBGC, Op. Cit.

[133] US PBGC, Op. Cit.

- firms with under-funded pension plans may come to view PBGC coverage as a fallback, for financial assistance. The very presence of PBGC insurance may create certain perverse incentives that represent moral hazard—struggling plan sponsors may place other financial priorities above "funding up" their pension plans because they know PBGC will pay guaranteed benefits;

- firms with onerous pension obligations and strained finances could see PBGC as a means of shedding these liabilities, thereby providing them with a competitive advantage over firms that deliver on their pension commitments. This would also potentially subject PBGC to a series of terminations of under-funded plans in the same industry, as has already seen with the steel and airline industries in the past 20 years; and

- firms may even have an incentive to seek (US) Chapter 11 bankruptcy in order to escape their pension obligations.[134]

172. These trends would increase the PBGC liabilities without any increase in its ability to meet these liabilities. Attachment 2 contains a summary of the recent US *Pension Protection Act 2006*, which in part attempts to address the funding problem.

Comment

173. The retirement savings protection regime in Australia differs considerably from those in the UK and US. As noted above, in Australia the majority of the benefits are in defined contribution funds and the major risk is that of theft or fraud. Despite the shift to defined contribution schemes in the UK and US, historically the major proportion of the retirement benefits have been provided through employer sponsored defined benefit pension schemes. The major threat to these schemes has been the insolvency of the employer/sponsor, or their withdrawal from the pension plan. Their retirement savings protection arrangements protect against this particular threat.

Trustee membership – Fit and Proper Person

174. As those with fiduciary responsibility trustees are expected to meet certain personal and professional standards. The following section summarises these standards as they apply in each country.

[134] David M Walker, US Comptroller General, *Testimony before the Sub-committee Government Management, Finance and Accountability,* Committee on Government Reform, US House of Representatives, Pension Benefit Guaranty Corporation – Structural problems limit agency's ability to protect itself from risk, 2 March 2005, pp. 9-10 at http://www.gao.gov/new.items/d05360t.pdf (accessed 23 March 2006).

Australia

175. The SIS Act requires that all superannuation fund trustees meet the required standards as a 'fit and proper' person.[135] The relevant regulations set out the matters to be considered when meeting these standards, as follows:

> (3) Subject to sub-regulations (5) and (6), an RSE licensee meets the fit and proper standard if the RSE licensee possesses relevant attributes that enable the RSE licensee to properly discharge the duties and responsibilities of an RSE licensee in a prudent manner.
>
> (4) The attributes include, but are not limited to:
>
> > (a) character, competence, diligence, experience, honesty, integrity and judgement; and
> >
> > (b) educational or technical qualifications, knowledge and skills relevant to the duties and responsibilities of an RSE licensee.[136]

176. APRA has provided additional guidance in the requirements to meet the 'Fit and Proper' test for trustees. This guidance notes that a person is not automatically prevented from being a superannuation fund trustee if they do not have the necessary level of technical knowledge concerning superannuation or investments. But they cannot be a trustee if they are a 'disqualified' person or have been prohibited from being a company director under the *Corporations Act 2001* (see further discussion below).[137]

177. Subsection 120A(3) of the SIS Act allows APRA to disqualify a person where they are not a 'fit and proper' person. It reads:

> The Regulator may disqualify an individual if satisfied that the individual is otherwise not a fit and proper person to be a trustee, investment manager or custodian, or a responsible officer of a body corporate that is a trustee, investment manager or custodian.

178. Further, guidance on the meaning of the term 'fit and proper' in relation to this particular section has recently been given by the Administrative Appeals Tribunal. In the

[135] *Superannuation Industry (Supervision) Act 1993* (SIS) subparagraphs 31(2)(ma), 32(2)(fa) and 33(2)(ba).

[136] Superannuation Industry (Supervision) Regulations 1994 Reg.4.14 and SIS s.121.

[137] Australian Prudential Regulation Authority (APRA*), Superannuation guidance note* SGN 110.1 – Fit and Proper, Guidance Notes and Circulars, July 2004 at http://www.apra.gov.au/Superannuation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=7364 (accessed 23 August 2006).

Tribunal's reasons for decision Deputy President S.A Forgie and Senior Member Mr B H Pascoe in the recent case involving APRA and the large insurance company AXA. After a lengthy survey of relevant authorities the Tribunal noted that:

- a wide variety of conduct can be used to determine whether a person meets the required standard of fitness and propriety;
- the standard included community confidence that certain conduct has not occurred and will not occur;
- primarily, a fit and proper person is one who can adequately carry out the functions and roles of the position being filled;
- in relation to SIS Act 120A(3) a person is not a fit and proper person if they cannot meet the required standards in SIS Act 120(1) and (2);
- a conflict of interest between the persons role as a trustee bound to act in the superannuation fund member's best interest and to act as an employer representative in the employer's best interest is not automatically grounds for a person not meeting the fit and proper test rather such conflicts have to be managed; and
- the existence of a conflict of interest can only be assessed in relation to the particular circumstances of each case.[138]
-

179. A disqualified person is one who:

at any time was convicted of a charge in respect of dishonest conduct

a civil penalty order was made in relation to the person

is an insolvent under administration

has contravened the *Corporations Act 2001* or the *Financial Sector (Collection of Data) Act 2001* on one or more occasions

the Regulator (APRA) if satisfied that the individual is otherwise not a fit and proper person to be a trustee, investment manager or custodian, or a responsible officer of a body corporate that is a trustee, investment manager or custodian

if a body corporate a receiver or manager or provisional liquidator has been appointed, or

[138] Administrative Appeals Tribunal, *Reasons For Decision*, *VBN and Ors and Australian Prudential Regulation Authority and Ors* [2006] AATA 710, p. 223 at 518 and following (accessed 30 August 2006).

the body has begun to be wound up.[139]

180. Currently APRA has the power to declare that an individual is not a 'fit and proper' person to be a superannuation fund trustee. The government has foreshadowed that this decision will be transferred to the Federal Court.[140] Apparently, this decision was taken in response to lobbying efforts following the decision by the Administrative Appeals Tribunal noted above.[141]

United Kingdom

181. Like Australia, section 3 of the UK *Pension Act 1995* (1995 Act) gives the UK Pension Regulator the power to prohibit a person from being an occupational retirement savings fund trustee if, in the opinion of the Regulator, they are not a fit and proper person for this role.[142] The Regulator will assess a person's fitness and propriety to be a trustee or to carry out various roles in relation to a UK occupational pension fund.[143]

182. The UK Regulator has issued guidance on what it will take into consideration in making this assessment, including (but not limited to):

- honesty and integrity;
- competence and capability; and
- financial soundness.

183. The matters that the UK Regulator would take into account when making a fitness and propriety assessment are (but not limited to):

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[139] *Superannuation Industry (Supervision) Act 1993* (SIS) s120, 120A.

[140] The Hon Peter Costello MP, 'Framework for reviewing administrative decisions by the Australian Prudential Regulation Authority (APRA)', *Media Release*, No 27, 16 April 2007.

[141] Eric Johnston, 'APRA put on a tighter leash', *Australian Financial Review*, 17 April 2006, p. 3.

[142] See s.33 of UK *Pensions Act 2004* for amendment to the 1995 Act.

[143] UK Pensions Regulator, Form S1 – Individuals application for entry into the Trustee Register or Key Person's statement of relevant fitness, experience and propriety (v3,03/05) at http://www.thepensionsregulator.gov.uk/pdf/forms1.pdf (accessed 25 August 2006).

- any attempt to deliberately deceive the regulator, or any other regulator
- any misuse of trust funds;
- any breaches of trust law if these are significant, persistent or deliberate;
- if a trustee were to persistently or seriously overcharge its clients;
- if trustees persistently or seriously breach pensions legislation or associated regulations; and
- convictions (other than those noted under section 29 of the UK *Pensions Act 1995* – see below) so far as these are not spent under the UK *Rehabilitation of Offenders Act 1974.* for example, these could involve convictions for violence or for drug or substance abuse.[144]

184. Though not formally linked to any definition of fit and proper, sections 247 and 248 of the UK *Pension Act 2004* require trustees of UK occupational pensions funds to have appropriate knowledge and understanding of the law relating to pensions and trusts, the principles relating to the funding of occupational pension schemes and the investment of the assets of such schemes. The required level of knowledge is that the trustees can properly exercise their function(s). Additional guidance has been given by the Regulator on this matter.[145] This guidance recognises that trustees may have to undertake appropriate training to carry out this role. The Regulator has provided such a training course.

185. Covering a similar range of offences as in Australian legislation, section 29 of the UK *Pension Act 1995* specifies who cannot be a trustee of a pension fund. A person (or company) cannot be a UK pension fund trustee if they have:

- been convicted of any offence involving dishonesty or deception;
- been adjudged bankrupt or sequestration of his estate has been awarded and (in either case) and has not been discharged;
- where the person is a company, if any director of the company is disqualified under this section;

[144] UK Pensions Regulator, Regulatory Activity, *Prohibition of Trustees*, Criteria for Fit and Proper Persons at http://www.thepensionsregulator.gov.uk/regulatoryActivity/prohibitedTrustees/prohibited-02.aspx (accessed 25 August 2006).

[145] UK Pensions Regulator, *Regulatory Code of Practice*, no. 7, Trustee knowledge and understanding (TKU), 30 May 2006, p. 6, at http://www.thepensionsregulator.gov.uk/pdf/CodeTkuFinal.pdf (accessed 25 August 2006).

- where the person is a Scottish partnership, if any partner is disqualified under this section;
- made a composition contract or an arrangement with, or granted a trust deed for the behalf of, his creditors and has not been discharged in respect of it;
- been subject to a disqualification court order;
- been removed as a trustee of a trust scheme by an order made by the High Court or the Court of Session on the grounds of misconduct or mismanagement in the administration of the scheme for which he was responsible or to which he was privy, or which he by his conduct contributed to or facilitated;
- the opinion of the Pension Regulator he is incapable of acting as such a trustee by reason of mental disorder; or
- if the person is a company which has gone into liquidation.

United States

186. A person who has been convicted of a wide variety of both personal and commercial offences and abuse of position violations cannot be a fiduciary (including a trustee), of, or serve in a number of other capacities in, a US retirement savings fund supervised under the US ERISA. This rule applies for a period of 13 years after such a conviction.[146] Arguably, US legislation goes further at this point than Australia or UK laws.

Comments

187. The Australian and UK provisions on who can be a superannuation fund trustee are very similar. Both countries have stringent provisions banning those convicted of commercial dishonesty from undertaking this role. Both countries do not require high levels of technical expertise upon undertaking this role, but require that trustees without the required knowledge quickly develop this expertise. Both countries have a ‘fit and proper’ requirement, with Australia’s requirement being more fully articulated than the UK’s.

188. The US requirements are noticeably different in that, formally under the relevant legislation, a person cannot be a fiduciary, or even fill major roles in a fund, if they have been convicted of one of a variety of serious offences against a person or other personal offences, i.e. such as offences against a person or involving illegal substances. The UK has similar

[146] US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, part 4, §1111 at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001111----000-.html (accessed 25 August 2006).

provisions, but has not legislated them, instead leaving such assessments to the discretion of the UK Pensions Regulator. To date, Australia has not formally addressed this issue.

189. Further, the disqualification from acting as a trustee in the Australian and UK systems is indefinite; the US system only prevents offenders from serving as a either a fiduciary, or in the administration of a fund, for a period of 13 years after conviction.

190. Both the Australian and UK systems emphasise the required levels of investment expertise and knowledge for a trustee of a retirement savings fund. The US system does not contain the same formal emphasise.

191. Finally, both the Australian and UK rules deal with the ineligibility of bodies corporate to be retirement savings fund trustees. The US rules appear to only deal with individuals being retirement savings scheme's fiduciaries or trustees. However, the US legislation clearly contemplates US corporate bodies also acting in these roles.

Trustee licensing

192. The safety of superannuation savings depends in the first instance on the quality of the trustees or fiduciaries that are entrusted with the management of these resources. One approach to ensuring that the highest possible standards apply to the performance of this function is to licence funds or register trustees with the relevant regulator.

Australia

193. From 1 July 2006 all APRA regulated superannuation funds must have a 'Registrable Superannuation Entity' (RSE) licence and must be registered with APRA.

194. Trustees of SMSFs and exempt public sector superannuation schemes (both not formally supervised by APRA) are not subject to these requirements. However, some public sector trustees have obtained an RSE licence. Only licensed superannuation entities can be registered with APRA.[147] Briefly, to qualify for an RSE licence entities must meet standards in relation to:

[147] Australian Prudential Regulation Authority, Superannuation - Licensing and Registering a Superannuation Entity - *Explanatory Guide on Licensing and Registration*, July 2004, p. 5 at http://www.apra.gov.au/Superannuation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=7189 (accessed 25 August 2006).

- fitness and propriety (discussed above);
- capital adequacy (discussed above);
- risk management; and
- adequacy of organisational and other resources.[148]

195. The precise standards applied to each entity will depend on the class of licence applied for and the business activities undertaken.

United Kingdom

196. The UK Pensions Regulator maintains a register of trustees for occupational based pension schemes. However, this register is used when the Regulator needs to appoint a trustee to protect benefits. The register is for professional trustees only.[149] The UK regulator also maintains a register of persons prohibited from being a trustee of an occupational pension fund.[150] Further, the Regulator also maintains a register of occupational and personal pension schemes, which includes the names of the scheme's trustees.[151] However, unlike Australia, there appears to be no requirement for a trustee of a UK occupational pension plan to be licensed.

United States

197. Unlike Australia, the US ERISA legislation does not appear to require that either trustees or fiduciaries of occupational retirement savings plans are registered with the EBSA or licensed by that body. Rather, §1102 of the ERISA requires that a named fiduciary appear in the instrument that establishes the retirement savings plan.[152] The named fiduciary is held

[148] See APRA *Guidance Notes* at http://www.apra.gov.au/Superannuation/Legislation-operating-standards-and-regulations.cfm (accessed 25 August 2006).

[149] UK Pensions Regulator, *Trustee Register*, at http://www.thepensionsregulator.gov.uk/trustees/trusteeregister/index.aspx (accessed 25 August 2006).

[150] S.66, *UK Pensions Act 2004*.

[151] Sections 59&60 UK *Pensions Act 2004*.

[152] US Code, Title 29, Chapter 18 Sub Chapter I, Subtitle B, Part 4, §1102 at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001102----000-.html (accessed 30 August 2006).

responsible for the operation of the plan in which their name appears. §1103 of the ERISA contains similar provisions for plan trustees.[153]

Employee/Employer representation

198. A significant problem for retirement savings has been the misuse of funds by employer sponsors. One way of countering this problem is to require that trustee boards have equal representation from employer(s) and employees.

Australia

199. Section 89 of the SIS Act requires that standard employer sponsored superannuation funds have equal numbers of employer and employee representatives on there trustee boards. If the employer sponsored fund is also open to the public it must still comply with the basic equal representation rule or have an independent trustee.[154]

United Kingdom

200. Sections 241 and 242 of the UK *Pensions Act 2004* require that at least one third of the trustees of a UK occupational pension scheme be member nominated. Section 243 of the same Act allows the relevant UK Secretary of State the power to raise this proportion to one half. To date, this step has not been taken. Section 32 of the UK *Pension Act 1995* requires that decision of the UK occupational pension fund trustee board may be taken by a majority vote. If the member nominated trustees in the UK are still only one third of the board, unlike Australia, UK employee representatives on trustee boards appear to be in a structurally weak position.

United States

201. Unlike Australia and the UK, the US ERISA legislation does not contain any requirements in relation to employee/employer representation for trustee or fiduciary boards of US workplace based retirement savings plans.

[153] ibid, §1103.

[154] S.93, *Superannuation Industry (Supervision) Act 1993*.

Role of Trustees – In whose interests are retirement savings schemes managed?

202. Requirements that a retirement savings scheme be managed in the sole interests of the members of that scheme may prevent some conflict of interest situations arising, between the interests of the members and the interests of any other party, such as an employer sponsor.

Australia

203. Subparagraph 52(2)(c) of the SIS Act requires superannuation fund entities duties and powers are performed and exercised in the best interests of the beneficiaries.

United Kingdom

204. Like Australia, the UK Pensions Regulator's guidance to trustees states that it is the trustees' duty to act in the best interests of the scheme beneficiaries. As far as investments are concerned this normally means their best financial interests.[155]

United States

205. Like Australia and the UK, the US ERISA requires that the schemes be managed in the interests the participants and beneficiaries.[156]

Role of trustees – Prudent person rule

206. One of the major regulatory safeguards is the prescribed level of conduct in investment matters expected of retirement savings plans trustees. There is a tension between managing a plan's investment assets to achieve the best returns and managing the investment risk. The expected level of conduct in this area is usually expressed in the 'prudent person rule'. The Organisation for Economic Cooperation and Development (OECD) has most recently summarised the prudent person rule as follows:

[155] UK Pensions Regulator, *Trustees*, Scheme Investments, at http://www.thepensionsregulator.gov.uk/trustees/guidance/schemeinvestments/invest-02.aspx (accessed 31 August 2006).

[156] US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, Part 4, §1104 at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001104----000-.html (accessed 31 August 2006).

> The governing body of the pension plan or fund and other appropriate parties should be subject to a "prudent person standard" such that the investment of pension assets is undertaken with care, the skill of an expert, prudence and due diligence.[157]

207. All three countries have mandated a similar standard of conduct for the investment of retirement savings fund assets.

Australia

208. Sub-section 52(2) of the SIS Act enshrines the prudent person rule in the following terms:

> (2) The covenants referred to in subsection (1) are the following covenants by each trustee of the entity:…
>
> (b) to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide;

209. This section prescribes various covenants that are taken as being included in Australian superannuation trust deeds, whether or not those trust deeds actually contain such language. Thus Australian superannuation trustees are bound by the above standard.

United Kingdom

210. The Prudent Person rule is not as clearly legislated in UK law as it is in Australian or US law (see below). But this does not mean that the principle is absent from a UK pension fund trustees' responsibilities.

211. Generally, in carrying out their powers and obligations, pension trustees in the UK are bound to exercise reasonable care and to show the prudence and diligence that an ordinary man of business would in the exercise of his own affairs. In the words of a 19th century court, the duty is to "take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound." [158] In

[157] OECD Directorate for Financial and Enterprise Affairs, *OECD Guidelines for Pension Fund Asset Management* – Recommendations of the Council, 23 March 2006, p. 6 at http://www.oecd.org/dataoecd/59/53/36316399.pdf (accessed 30 August 2006).

[158] *Re Whitely* (1886) 33 Ch D 347as cited in Moore, N. "Trustees' Duties in Relation to Money Purchase Pension Schemes" in Tolley's *Trust Law International* vol. 13, no. 1 (1999). cited in OECD, Directorate for Financial, Fiscal and Enterprise Affairs, Insurance Committee, Working Party on Private Pensions, 'Prudent

accordance with common law principles, pension trustees also have a general duty to invest the pension scheme's assets and not allow them to sit idle, unless immediately required for the payment of benefits or other purposes.

212. In addition to these common law obligations, the powers and duties of pension trustees are further codified at sections 33–36 of the UK *Pensions Act 1995*. One commentator has summarised these requirements as "The trustee and any person to whom the function has been delegated, has a duty of care to exercise skill in the performance of the investment function, exercising any special skills they may possess."[159]

213. The UK Pension Regulator has summarised these requirements as 'The duty to act prudently means you [the Trustee] must act in the way that a prudent person would in their own affairs. In doing so, you must use any skills and expertise you have. This duty is particularly relevant to selecting and dealing with the scheme's investments…',[160]

United States

214. Like Australia, the US ERISA states the prudent person principal in the following terms:

> **(1)** Subject to sections 1103 (c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties ….
>
> **(B)** with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;[161]

Person Rule – Standard for the Investment of Pension Fund Assets, DAFFE/AS/PEN/WD/(2001)15/REV1, 18 June 2002, p. 9.

[159] OECD, Directorate for Financial, Fiscal and Enterprise Affairs, Insurance Committee, working Party on Private Pensions, 'Prudent Person Rule – Standard for the Investment of Pension Fund Assets, DAFFE/AS/PEN/WD/(2001)15/REV1, 18 June 2002, p. 9.

[160] UK Pensions Regulator, *Trustees*, Fiduciary Duties of a Trustee at http://www.thepensionsregulator.gov.uk/trustees/guidance/fiduciaryduties/duties-08.aspx (accessed 31 August 2006).

[161] US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, Part 4, §1104 at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001104----000-.html (accessed 31 August 2006).

215. Although the ERISA prudent person rule essentially codifies the common law, US courts have in fact interpreted this codification of the law to be a more exacting standard. One often-quoted judicial opinion stated that the duties of an ERISA trustee are “the highest known to the law.”[162]

Risk management – Controls on investment strategy

216. Each country requires that the assets of a retirement savings fund are invested in a diversified portfolio, taking into account the whole circumstances of the fund.[163]

In house asset rules

217. An ‘in-house’ asset is one that is associated with the sponsor of the retirement saving scheme. For example, a scheme may hold a significant proportion of its assets in the shares in the employer sponsor’s company. Each country has limits on the amount of in-house assets that a retirement savings scheme may hold.

218. There are several dangers for a retirement savings fund in holding in house assets. Obviously, if the employer sponsor ceases operation the value of those assets is most likely nil. This has been a particular problem in the US. Further, a fund’s holding of in house assets, say a series of loans to the sponsor, may provide an avenue for that sponsor to have undue influence on the fund. Limits on in house assets prevent sponsors using a fund as a source of finance for their business.

Australia

219. Sections 82 through to 83E of the SIS Act limit a superannuation fund’s holdings of in-house asset to no more than 5 per cent of the market value of the portfolio.

[162] OECD, Directorate for Financial, Fiscal and Enterprise Affairs, Insurance Committee, Working Party on Private Pensions, ‘Prudent Person Rule – Standard for the Investment of Pension Fund Assets, DAFFE/AS/PEN/WD/(2001)15/REV1, 18 June 2002, p. 11.

[163] Australia, 4.09 Superannuation Industry (Supervision) Regulation 1994, UK sections 35 and 36 *Pension Act 1995*, US, US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, Part 4, §1104 at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001104----000-.html (accessed 31 August 2006), and US Federal Regulations, Part 2550 – Rules and Regulations for Fiduciary Responsibility, §2550.404a-1 – Investment Duties at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=98b4339e421cd757a42382475ab1bd75&rgn=div8&view=text&node=29:9.1.3.6.5.0.16.4&idno=29 (accessed 31 August 2006).

United Kingdom

220. Likewise, a UK occupational pension scheme is generally limited to holding no more than 5 per cent of their portfolio in the form of in-house assets.[164]

United States

221. Generally, the US ERISA restricts workplace defined benefit pension plans to holding no more than 10 per cent of their portfolio in the form of in-house assets (known as qualifying employer securities or employer real property in the US).[165] The recently legislated US *Pension Protection Act 2006* gives individual members the right to divest their individual accounts of qualifying employer securities.[166]

222. Unlike Australia and the UK, there appears to be no limit on the amount of qualifying employer securities that a US workplace defined contribution retirement savings scheme may hold. As defined contribution plans have become wide spread in the US there are rising levels of concern at the widespread presence of employers' own stock in their portfolios. In extreme cases, over 90 per cent of portfolio's consist of qualifying employer securities.[167]

Borrowing

223. Generally, trustees of Australian and UK retirement savings funds are not allowed to borrow from an external party, save for certain limited and temporary purposes.[168] US legislation does not address this point and it may be the case that US fiduciaries are able to borrow on behalf of their funds.

[164] UK Pensions Regulator, Trustees, Guidance, Scheme Investments at http://www.thepensionsregulator.gov.uk/trustees/guidance/schemeInvestments/invest-07.aspx (accessed 31 August 2006).

[165] US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, Part 4, §1107 at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001107----000-.html (accessed 31 August 2006).

[166] Staff of US Joint Committee on Taxation, TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006," AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, p. 217 at http://www.house.gov/jct/x-38-06.pdf (accessed 31 August 2006).

[167] William Even and David Macpherson, *The Causes and Consequences of Pension Fund Holdings of Employer Stock*, Research undertaken for the US Dept of Labour Employees Benefit Security Administration, 2004, pp. 4 - 6.

[168] Sections 67, 95 & 97 SIS, s. 36A UK *Pensions Act 1995* (inserted by s. 246, UK *Pensions Act 2004*).

Vesting

224. Vesting refers to beneficial ownership of a retirement savings fund's assets in the individual member. When a member gains beneficial ownership of the assets of a fund those assets are said to vest in that particular member. Significant delays between the accumulation of a retirement benefit, and the point at which those benefits vest in the member, lessens the security of the benefit. For during the intervening period the benefits may be taken away by the employer sponsor or disappear due to the employer sponsor ceasing operation.

Australia

225. The SIS and associated regulations required that member's 'minimum benefits' be protected at all times. These benefits are made up of both the members and employers contributions and the associated earnings.[169] Further, trustees must credit all contributions to accumulation funds and the majority of contributions to defined benefit funds to the members account within 28 days of the end of the month in which those contributions have been received.[170] Though these rules are not a formal vesting rules, these minimum benefits cannot be reduced by according to the time an employee has spent with a particular employer. Nor can a contribution be held back from being credited to a member's account, where they become a part of the member's minimum benefits. Thus the overwhelming proportions of Australian superannuation benefits are immediately vested in the members.

United Kingdom

226. The UK Pensions Regulator's code of practice encourages those leaving their occupational pension scheme after more than 3 months service, who do not have vested benefits under the particular scheme's rules, to have a cash amount transferred to another scheme.[171] This implies that the benefits in the Fund, or their equitant value, are vested in the member.

[169] Subsection 31(2)(b) *Superannuation Industry (Supervision) Act 1993* and more generally APRA, Superannuation Circular No. I.C.1 – Minimum Benefit Standards, December 1998.

[170] Regulations 7.08 and 7.11 Superannuation Industry (Supervision) Regulations 1994.

[171] UK Pensions Regulator, Regulatory Code of Practice No. 4, Early Leavers – Reasonable Periods, p. 6 at http://www.thepensionsregulator.gov.uk/pdf/codeEarlyLeaversFinal.pdf (accessed 1 September 2006).

United States

227. Unlike Australia and the UK there are sometimes lengthy delays in vesting retirement benefits in the members of US workplace pension schemes. Generally, benefits arising from US workplace based pension schemes are not required to fully vest in the member for either 3 or 5 years of service. The relevant legislation allows for portions of the benefit to partly vest after shorter periods of service. Nothing in the US legislation prevents benefits from fully vesting in scheme members after shorter periods of service.[172] These provisions were strengthened by the recent US *Pension Protection Act 2006*.[173]

Disclosure – informing members

228. An important method of ensuring the safety of retirement saving schemes is to require that the scheme regularly reports to its members. In theory, members will notice any undue discrepancies in the accumulation of their benefits and take appropriate action.

Australia

229. The *Corporations Act 2001* requires that the holder of a financial product (defined to include a superannuation fund) receive a report from the issuer of that product every 12 months.[174] The content of such reports is to include:

- opening and closing balances for the reporting period;
- the termination value of the investment at the end of the reporting period (to the extent to which it is reasonably practicable to calculate that value for the investment or a component of the investment);
- details of transactions in relation to the product during the reporting period as required by regulations made for the purposes of this paragraph;
- any increases in contributions in relation to the financial product by the holder or another person during the reporting period;

[172] US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, Part 2, §1053 at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001053----000-.html (accessed 1 September 2006), also s. 264 *UK Pensions Act 2004.*

[173] Staff of the US Joint Committee on Taxation, ibid, p. 240.

[174] S. 1017D, *Corporations Act 2001*.

- return on investment during the reporting period (on an individual basis if reasonably practicable to do so and otherwise on a fund basis);
- details of any change in circumstances affecting the investment that has not been notified since the previous periodic statement; and
- relevant details prescribed by regulations.[175]

United Kingdom

230. Section 41 of the UK *Pension Act 1995* allows for relevant regulations to require that annual reports be given to members of occupational pension schemes. Unlike Australian requirements, these regulations only allow for general information to be provided to members, not specific information on the individual member's benefits.[176] To be fair, these regulations allow for an individual member to be informed of the size of their benefits when they are payable![177] These regulations are currently under review.[178]

United States

231. Currently, the law generally requires pension and profit-sharing plan administrators to give information to members about their benefits if they request this information in writing. Under the provisions of the recently passed US *Pension Protection Act 2006*, from 31 December 2006 members of defined benefit pension plans will be required to automatically provide individualized benefit statements to employees working under the plan every three years, unless they notify employees once a year that the statements are available. For retirement savings plans, such as 401K plans, where employees have control over their investment choices, statements must be provided once every quarter. Other individual account plans, such as profit-sharing plans, employee stock ownership plans, and those 401K plans where employees do not have control over their investments, will have to provide benefit statements once a year.[179] The US code also requires that information provided shall

[175] Subsection 1017d(5), *Corporations Act 2001*.

[176] Schedule 1, UK Occupational Pension Schemes (Disclosure of Information) Regulations 1995 at http://www.opsi.gov.uk/si/si1996/Uksi_19961655_en_2.htm (accessed 1 September 2006).

[177] Regulation 5 and Schedule 2, ibid.

[178] UK Pensions Regulator, *Discussion Paper* – A review of the form and content of pension scheme reports and accounts, June 2006 at http://www.thepensionsregulator.gov.uk/pdf/reportAccountsDiscussionPaper.pdf (accessed 1 September 2006)

[179] US Pension Rights Centre, Individual Benefit Statements, at http://www.pensionrights.org/policy/legislation/statements.html (accessed 1 September 2006) see also s.508 US

be written in such a way that it can be understood by the average plan participant.[180] These requirements are very similar to Australian requirements outlined above.

Role of Auditors

232. The ability of an independent expert to report breaches of the law or emerging problems is an important safeguard for retirement savings.

Australia

233. Sections 129, 130 and 130A of the SIS Act require an appointed auditor of an Australian Superannuation fund to report to the regulator if:

- it is likely that a contravention of the SIS legislation or other laws may have occurred, may be occurring, or may occur in relation to the superannuation entity;
- the financial position of the entity may be, or may be about to become, unsatisfactory; or
- the auditor has information that they consider may assist the regulator (APRA) in the performance of its functions.[181]

United Kingdom

234. In a similar manner to Australian requirements, the UK Pensions Regulator's Code of Practice specifically requires auditors (and a wide range of other professionals and service providers) to report material breaches of both pension and trust law.[182] Unlike Australian

Pension Protection Act 2006 at http://www.pensionrights.org/policy/legislation/Pension_Bill_06/Pension%20Bill%20-%20Individual%20Benefit%20Statements.pdf (accessed 1 September 2006).

[180] US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, Part 1, §1022(a) at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001022----000-.html (accessed 4 September 2006).

[181] Australian Prudential Regulation Authority, Guidance notes and circulars, *Superannuation Circular* IV.A.6 Responsibilities of the approved auditor, June 2005, p. 6. at http://www.apra.gov.au/Superannuation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=8853 (accessed 1 September 2006).

[182] UK Pensions Regulator, *Regulator Code of Practice* 01, Reporting Breaches of the Law, p. 6 and following, at http://www.thepensionsregulator.gov.uk/pdf/reportingBreachesCop.pdf accessed 1 September 2006).

requirements, emerging problems, or information that may be of assistance to the regulator, is not required to be reported.

United States

235. United States legislation does not appear to address this issue. However, if the employer sponsor of a US defined benefit workplace based pension plan fails to make the required contributions, it must inform the beneficiaries of this failure (see below on missing contributions).[183]

Missing Contributions

236. One of the most significant safety issues for retirement savings is the reliability of contributions from those who are obliged to make them. Generally, employers are obliged to make these contributions. But what legislative provisions apply to ensure compliance?

Australia

237. In Australia, compulsory superannuation contributions are made by employers on behalf of employees who are paid in excess of $450 per month. In an employer fails to make the required contributions within 28 days of the end of a calendar quarter they are subject to some minor administrative penalties.[184] However, if they fail to make the required contributions by the 28th day of the second month after the end of the calendar quarter they are liable for the full penalty, known as the Superannuation Guarantee Charge (SG Charge) plus the normal contribution to the employee's superannuation fund. That is, if a payment is not made before the end of the second 28 day period, the employer effectively makes a double payment to the Australian Tax Office (ATO), plus penalties discussed below.

238. The SG Charge is made up of the sum of the SG Shortfalls as well as the penalty components discussed below. The SG Shortfall is the difference between the amount paid and the amount that should have been paid by the employer on behalf of the employee.

[183] US Code, Title 29, Chapter 18, Subchapter I, Subtitle B, Part 1, §1021(d) at http://www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00001021----000-.html (accessed 5 August 2006).

[184] S. 23A *Superannuation Guarantee (Administration) Act 1993*. If the payment in respect of the previous quarter is made after the first 28 day period, but before the second 28 day period, most of the employer's liability is offset by an amount equal to the actual amount of the contribution to the superannuation fund. Generally, the amount of the contribution is required, plus some administrative charges. However, if the required payment is not made by the 28th day of the second month following the end of the relevant calendar year quarter the employer is liable for the full SG charge.

239. There is a considerable 'penalty' component in the calculation of the SG Charge. Far from being simply a mechanism to compensate the employee for the under-contribution, the SG Charge may comprise a number of separate penalties. From 1 July 2003, these are:

- an administration fee of $20 for each employee for whom there has been an underpayment of contributions;
- "salary and wages" being the basis of calculation of the SG charge, rather than the generally lower ordinary time earnings;
- 10% pa interest calculated from the start of the relevant quarter rather than from the date the contributions should have been made;
- the SG charge is not tax deductible, whereas the superannuation contribution would have been; and
- further penalties may be imposed for failure to keep records and other offences.

The first four penalties are automatic and apply even if the contributions are made shortly after the due date. Only the fifth is at the Commissioner's discretion.[185]

240. Where the amounts are paid to the ATO, the employee's nominated superannuation fund will receive the equivalent of the total shortfall (i.e. the contribution that should have been paid), plus the interest component to compensate the employee for the late payment.[186]

241. In the first instance, where the employer has not made a payment, or made the required payments later than required, they must report this matter to the ATO. This approach is consistent with the self assessment approach of the Australian taxation system, where those liable to make a payment have the initial responsibility to assess their own liability.

242. Should an employee consider that the employer is not making the required contributions they can contact the ATO and request that this be followed up directly with the employer. The ATO will also undertake company visits and audits to ensure that the required superannuation guarantee payments are made.[187] Clearly the focus of these arrangements is on the individual superannuation account holder to check that the required contributions are made to their account.

[185] CCH *Australian Master Superannuation Guide 2006/07*, Topic 12-310.

[186] Australian Taxation Office, *Superannuation Late Payment Offset* – Effective 1 January 2006, at http://www.ato.gov.au/super/content.asp?doc=/content/67148.htm&page=12&H12 (accessed 2 April 2007).

[187] Australian Taxation Office, *Superannuation Guarantee – a guide for employers* – How we ensure that employers are meeting their obligations, at http://www.ato.gov.au/superprofessionals/content.asp?doc=/content/19818.htm&page=61&H61=&pc=001/006/018/012/002&mnu=30413&mfp=001/006&st=&cy=1 (accessed 4 April 2007).

United Kingdom

243. The contributions to occupational defined benefit funds in the United Kingdom are determined by the Trustees of that fund, in consultation with the employer(s) making the relevant contributions. Where the employer(s) fail to contribute, and this is a significant failure, the relevant fund Trustees must inform the UK Pensions Regulator of this event. This notification must occur within a reasonable period, which is generally considered to be within in 10 working days of the Trustees first becoming aware of this failure. They must also report this failure to scheme members within a reasonable period of time, in this case defined as within one month of the Trustees first becoming aware of this failure.[188]

244. In the UK accumulation, or defined contribution, funds are also known as 'money purchase' funds. If an employer fails to contribute to a money purchase scheme, and this is a significant failure, the Trustees of the scheme also have to report this failure to the UK Pensions Regulator within a reasonable period of time; defined as 10 days after a period of 90 days has elapsed without the contribution being made. Members also have to be informed of this failure within a 30 day period after the initial 90 day non-contribution period has passed.[189]

245. Once a failure to contribute has been identified the UK Pensions Regulator may respond in a number of ways, depending on the cause of the problem. These responses range from investigation and issuing specific guidance, ensuring that the employer is aware of their obligations, issuing specific improvement notices for improving administration of pension contributions and monitoring the employers progress in making up the missing contributions. The Regulator may prosecute the employer to recover the missing contributions if required.[190]

[188] UK Pension Regulator, *Regulatory Code of Practice* 03, 'Funding defined benefits' February 2006, paragraphs 161 to 167, at http://www.thepensionsregulator.gov.uk/pdf/codeFundingFinal.pdf (accessed 5 April 2007).

[189] UK Pensions Regulator, *Regulatory Code of Practice* 05, 'Reporting of late payment of contributions to occupational money purchase schemes, May 2006, at http://www.thepensionsregulator.gov.uk/pdf/codeLpmpsFinal.pdf (accessed 5 April 2007).

[190] UK Pensions Regulator, 'Regulatory Activity', A regulatory scenario, at http://www.thepensionsregulator.gov.uk/regulatoryActivity/regPara-03.aspx (accessed 5 April 2007). This site gives examples of the range of actions available to the UK Pensions Regulator to ensure that the appropriate contributions are made. See also sections 12 – 17 UK *Pensions Protection Act 2006* at http://www.opsi.gov.uk/ACTS/acts2004/40035--b.htm#16 (accessed 5 April 2007).

United States

246. Under the recently passed US *Pensions Protection Act 2006* employers are legally required to pay the required contributions into a retirement scheme.[191] Should an employee consider that their employer may not be making the required contributions to their plan they may seek help from the US Department of Labour's benefits advisors. These advisors resolve benefit disputes, conducting investigations, and seeking correction of violations of the law, including bringing lawsuits when necessary.[192] The employee retains the right to sue their employer over a number of employee benefit related matters, including where the employer does not make the minimum required contributions to the employees retirement plan.[193]

Comment

247. The most startling difference between the three countries is the entity/person who is first responsible for identifying that the required contributions to a retirement fund have not been made. In Australia it is the employer themselves, under the self assessment system. In the UK, it is the trustees of the retirement fund or scheme. In the US the employer making contributions to a defined benefit fund is required to report to the members, otherwise it is the individual is the first party required to act on this matter. In each country, if the initial actions by any party do not produce the desired result the government agency concerned may take action to recover the outstanding contributions, if other approaches fail to produce the required result.

248. The Australian arrangements are unique, in that the recovery of missing contributions is made through the taxation system. This has the advantage of avoiding litigation to recover outstanding contributions, should other approaches prove unsuccessful. In contrast, where an employer in either the US or UK does not finally make the necessary contributions the relevant regulators, or affected individual in the US, must take this matter to court.

249. Finally, under the Australian approach, the penalties for not making the contributions on time are clearly set out and are quite severe. While there may be penalties imposed by the courts in the US and UK (should recovery action come to that point) the severity of these penalties appears much less certain.

[191] Title I US H.R.R, *Pension Protection Act 2006*, at http://thomas.loc.gov/cgi-bin/query/D?c109:4:./temp/~c109bmCcVx: (accessed 5 April 2007).

[192] US Department of Labour, *Employment Law Guide*, 2005, C – Health Benefits and Retirement Standards, p. 38, at http://www.dol.gov/compliance/guide/lawguide_2006.pdf (accessed 5 April 2007).

[193] US Department of Labour, Employee Benefits Security Administration, *What you should know about your retirement plan*, Chapter 10 – What do you do if you have a problem, at http://www.dol.gov/ebsa/publications/wyskapr.html (accessed 5 April 2007)

Handling Complaints

250. Retirement scheme members may disagree with the trustees of their scheme, the regulator, or the government on a variety of matters. For example, a scheme member may consider that they are entitled to payment of a benefit due to their continued inability to work. There may be disputes on validity of various investments, such as disputes on whether investment in a particular asset breaches Australia's sole purpose test for superannuation investments.[194] Other disputes may concern the distribution of a deceased member's benefits. The presence of a low cost, independent mechanism for resolving such disputes can be seen as a necessary component of a country's retirement saving system.

Australia

251. Section 921A of the *Corporations Act 2001* requires the holder of an Australian Financial Service Licence (including the trustees of large Australian superannuation funds) to have internal dispute resolution procedures to handle complaints made by their members and also to be themselves members of an approved external dispute resolution scheme. These schemes must meet the requirements of the Australian Securities and Investment Commission. The Australian Superannuation Complaints Tribunal (the Tribunal) requires that complaints first make use of a fund's internal dispute resolution mechanisms before approaching it to deal with a complaint.

252. If the particular Fund's internal dispute procedures fail to solve a complaint a member (or other related parties) may approach the Tribunal. It is an independent, dispute resolution body which deals with a diverse range of superannuation-related complaints and offers a free, 'user friendly' alternative to the court system.

253. The Tribunal is empowered to deal with complaints relating to the decisions and/or conduct of trustees, insurers, retirement savings accounts (RSA) providers, superannuation providers and other relevant decision-makers in relation to regulated superannuation funds, approved deposit funds, life policy funds, annuity policies, RSAs and the surcharge contributions tax.

254. However, this body does not have an unlimited jurisdiction to deal with all superannuation-related grievances. Very stringent jurisdictional and standing provisions have been built into the SRC Act in the form of mandatory time limits and statutory 'interests' to ensure that the Tribunal may only deal with those matters which can 'fairly' be dealt with in an economic, informal and quick manner according to its statutory objectives.[195] Its

[194] Briefly, the 'sole purpose' test specifies that an Australian superannuation fund's investments must be made solely for the purpose of providing retirement or death benefits to the member and their dependents. The most notorious case in Australia regarding the 'sole purpose' test involved a fund's purchase of a Swiss chalet, which was used exclusively by the member and his associated (Case 43/9595 ATC 374).

[195] Superannuation Complaints Tribunal, *Annual Report*, 2005-06, p. 10.

procedures require that the matter must have been first lodged with the superannuation fund and have been dealt with by that entities internal dispute resolution mechanism.

255. While the Tribunal can hear complaints concerning most superannuation funds, it cannot hear complaints involving:

- 'excluded funds' under the SIS (public sector superannuation schemes);
- self managed superannuation funds;
- funds that are unregulated under the SIS;
- matters that occurred before a fund became a regulated fund under SIS;
- total and permanent disability claims outside provision of the SRC Act;
- the actions of employers in relation to the fund; and
- matters currently before a court.[196]

256. Time limits for making a complaint apply, depending on the type of complaint. For example, complaints involving a trustee's decision on the payment of permanent disability benefits must be made within 2 year of the trustee's original decision. Shorter time limits apply for complaints involving a trustee's decision on the distribution of deceased member's benefits.[197]

United Kingdom

257. As in Australia, Pension Funds in the UK are required to have internal dispute resolution procedures.[198] In the first stage a relevant pension manager of a scheme deals with a complaint. In the second stage, if the complainant is not satisfied by the outcome of the first stage, they may request a scheme trustee to deal with the complaint. The second stage must commence within 6 months of the first stage decision. If this procedure does not resolve the dispute then the complainant may approach the UK Pensions Ombudsman.[199]

258. In the UK the Pension Ombudsman may investigate and determine complaints and disputes brought to him by pension scheme members, ex members, widows, employers,

[196] Op. Cit., p. 26.

[197] Superannuation Complaints Tribunal Website, *Superannuation Funds (including Approved Deposit Funds)* at http://www.sct.gov.au/Making_a_complaint/default.asp?images=b (accessed 18 April 2007).

[198] Section 50 UK *Pension Act 1995*.

[199] UK the Pension Advisory Service, *Internal Dispute Resolution Procedure*, at http://www.pensionsadvisoryservice.org.uk/disputes/internal_dispute_resolution/ (accessed 18 April 2007).

trustees or managers of occupational pension schemes.[200] Complaints must be of maladministration, though it is not necessary for consequential injustice to be alleged. Disputes must be of fact or law. The Ombudsman's determinations are enforceable and may only be challenged through the Courts.

259. The Ombudsman can investigate complaints and disputes about occupational or personal pension schemes. For example, stakeholder schemes, statutory public sector schemes, private company/employer schemes or individual personal arrangements. Complainants are advised to make use of any internal complaints resolution arrangements that a pension scheme may have, but this does not appear to be a necessary preconditions for making use of this service.[201]

260. However, the UK Pensions Ombudsman does not:

- deal with the way that pension products are sold or marketed – complaints about this are dealt with by the Financial Ombudsman Service
- deal with complaints about State pensions or benefits, or
- deal with matters subject to court proceedings unless the proceedings have been discontinued without a settlement.[202]

261. Additionally the Ombudsman usually will not investigate matters which are subject to regulation by the Pensions Regulator unless they have completed an investigation or decided not to investigate. There are certain matters regulated by the Pensions Regulator that the Ombudsman cannot make findings about. Also the Pensions Ombudsman usually will not investigate any complaint that has been, or is being, investigated by any other ombudsman. Generally, complaints have to be made within 3 years of the act being complained about, though this time limit may be extended to 6 years, depending on the facts of the case.[203]

United States

262. United States legislation does not require the fiduciaries of a pension plan to maintain any procedures for the resolution of complaints. However, the US Employees Benefits Administration (EBSA) encourages plan members with a complaint to first approach their

[200] Section 146 of the UK *Pension Schemes Act 1993*, as amended by the UK *Pensions Act 1995*

[201] UK Pension Ombudsman, *The Pension Ombudsman – How he can help you, 26 August 2005, p. 2, at http://www.pensions-ombudsman.org.uk/publications/docs/Booklet2005.pdf (accessed 18 April 20070.*

[202] ibid.

[203] UK Pension Ombudsman, *Powers*, at http://www.pensions-ombudsman.org.uk/powers/#excluded (accessed 18 April 2007).

plan's administrator.[204] If this approach does not resolve the complaint a member may bring their complaint to an EBSA Benefit Advisor. These Advisors are able to investigate a complaint and enforce corrective action if necessary.[205] Alternatively, plan members retain the right to sue the plan's fiduciaries. The are protected from retaliatory action on the part of an employer if they enforce their rights by either taking the complaint to the Benefits Advisor or when undertaking legal action.[206]

Comment

263. There are no formal requirements for an RSE licence holder to maintain an internal dispute resolution process; though such licence holders would have to appear as a respondent at any Tribunal hearing or conciliation process. As noted above, all holders of an Australian Financial Services Licence must maintain and participate in the above dispute resolution process. Further, a large number of Australian RSE licence holders are also holders of an Australian Financial Services Licence. However, not all RSE licences holders also hold an Australian Financial Services Licence. Consequently, there may be a number of RSE Licence holders that do not have an internal dispute resolution process. Members of funds in this position may have no informal avenues to resolve any disputes with an RSE Licence holder. Information on the number of RSE licence holders who do not also hold an Australian Financial Service Licence is not currently available.

Section 5 - Conclusions

264. The Committee's terms of reference for this inquiry focus on the structure and operation of the *Superannuation Industry (Supervision) Act 1993* and the superannuation industry. The aim of this inquiry is to assess whether the current Australian legislation and industry practice provides an efficient, effective and safe regulatory structure for the management of superannuation funds. With this overall aim in mind the following conclusions will focus on areas where a comparison with the regulatory structure of the United Kingdom and the United States may suggest areas for improvement in Australian regulation and practice.

265. While the United States appears to have a clear advantage in regulatory overlaps and administrative simplicity compared to the UK and Australia, of itself this is not a reason to move to a US style system. The US system places greater emphasis on the individual and

[204] US Employee Benefit Plan Administration, *What you Should Know About Your Retirement Plan*, Chapter 10: What to do if you have a problem, at http://www.dol.gov/dbsa/publications/wyskapr.html (accessed 19 April 2007).

[205] US Employee Benefit Plan Administration, *Enforcement Manual* at http://www.dol.gov/ebsa/OEManual/main.html (accessed 19 April 2007).

[206] ibid.

their employer to make appropriate retirement arrangements. Consequently, the US government has less perceived responsibility to ensure that these arrangements are safeguarded by various regulatory arrangements. As noted above, this is not the approach taken in either the UK or Australia.

266. The effectiveness of advice offered by retirement fund providers in Australia, to members of the provider's funds can be questioned. While it may be the case that advisors employed by the superannuation providers are separate from the overall management of the retirement funds, it also may be the case that the motive for a provider offering this advice is to retain the member's retirement funds under the same management. However, the prevalence of commission based payment for advice in all countries suggests that separating investment advice from the retirement fund provider will not necessarily produce a higher standard of advice for the member upon retirement.

267. An Australian superannuation fund trustee may be in a difficult position when a member exercises an inappropriate investment choice. On the one hand they are charged with acting prudently in respect of the funds investments. But they are effectively prevented from doing so if a member selects an investment option that is less than prudent in their particular circumstances. While legislation in both Australia and the UK shield the trustee from the consequences of a member's inappropriate choice (providing they have met the relevant regulatory requirements in allowing such choices to be made) further consideration may need to be given to tightly defining when a trustee's obligation to prudently manage a fund's investments applies – and when it does not apply.

268. The increasing international mobility of labour is an often mentioned theme. As noted above, the recognition of other country's retirement systems when employing foreign nationals appears to be tied to the existence of the appropriate double tax or social security and superannuation treaties between the relevant countries. While tying the recognition of another country's retirement income system to the existence of the appropriate treaty ensures reciprocal treatment for Australian nationals working in that other country, it also potentially limits the number of foreign workers who can take advantage of this type of provision and work in Australia.

269. Australia does not currently have a Social Security and Superannuation agreement with the UK. There are very sound reasons for the lack of such a treaty. However, it is interesting to note that the UK has arrangements recognising a UK employer's contribution to a qualifying Australian superannuation fund, while Australia has no such arrangements in respect of the UK. This could amount to a restriction on the supply of UK nationals able to work in Australia on a temporary basis.

270. Australian standards for the fitness and propriety of a superannuation fund trustee differ from those of the US and UK in relation to an individual's prior or future convictions in relation to personal offences, particularly offences relating to prohibited substances. Further consideration may need to be given to formally including such restrictions in Australian criteria for who is a fit and proper person to be a superannuation fund trustee. However, if

this approach was adopted, fairness would require some time limits to be placed on the effects of such convictions, as is done in the US.

271. A particular weakness in any system for recovering unpaid superannuation contributions is the extent to which the system relies on those making the contributions (usually employers) or individuals first noticing any deficiency. Employers may have a very strong motivation for not informing the ATO of this problem. Individuals may lake the skills, or information, or motivation (or all three) to address this problem.

272. In Australia, the ATO may uncover instances of unpaid contributions, but it appears that the individual is expected to take a sufficient interest in their own affairs to alert the ATO to any outstanding problems. In contrast, in the UK Trustees are required to report any significant failures to make the required superannuation contributions within a very short time frame. Such a system may be of great benefit for the operation of the Australian system.

273. As noted above, there may be a number of Australian RSE licensees that do not also hold an Australian Financial Services Licence. Such RSE licensees are not necessarily required to maintain an internal dispute resolution process. Further thought may need to be given to requiring such RSE licensees to have formal internal dispute resolution processes in place as a condition of their licence.

Attachment 1 – Extracts from the Report of the Taskforce on Reducing the Regulatory Burden on Business – January 2006.

The structure of financial sector regulation in Australia is based on the so-called 'twin peaks' model, with APRA responsible for prudential regulation and ASIC focusing on investor protection and market integrity. A fundamental challenge arising from the twin peaks model is the need for the two regulators, notwithstanding their different roles, to maintain a high level of cooperation and coordination on regulatory development and administration. This is necessary to ensure that regulatory approaches do not conflict or overlap and that compliance costs are not imposed where differing regulation of a similar issue is required. It is also important that APRA and ASIC cooperate to ensure their supervisory activities are coordinated.

APRA and ASIC sometimes impose regulatory requirements in the same areas, although the requirements may differ somewhat to reflect the underlying policy objectives. But it is important that there is effective coordination to avoid, where possible, unnecessary costs associated with meeting differing regulatory requirements, including additional compliance infrastructure and staff training.

Comments received by the Taskforce during consultations identified concerns with the level of coordination and cooperation between APRA and ASIC. Areas of concern included the regulators allegedly not sharing documentation and information provided as part of a licensing process; and a lack of cooperation where entities under investigation by both regulators were required to meet separately with APRA and ASIC and provide similar information. Stakeholders also identified concerns about cooperation between the regulators and the Australian Taxation Office (ATO) on superannuation matters, in particular, the consistency of interpretation and enforcement of superannuation requirements by APRA, ASIC and the ATO.

Stakeholders identified several specific areas where there is scope to achieve greater consistency in the regulatory approach and so reduce the compliance burden on regulated entities. The Taskforce understands that APRA and ASIC have established a joint working group to review areas of perceived regulatory overlap or duplication between the two agencies.

Breach reporting requirements

The Taskforce received comments from a range of stakeholders outlining concerns with the breach reporting requirements of APRA and ASIC. In broad terms, APRA requires any breaches of prudential requirements to be reported, while ASIC imposes a materiality test to limit reporting to breaches that may represent a significant risk. The timeframes for reporting breaches also differ. The rationale for the differing requirements is that APRA is seeking to identify early indications of potential problems.

However, the stricter requirements impose costs on regulated entities through the need to maintain separate compliance and reporting procedures.

The Taskforce considers that the government, APRA and ASIC should amend the breach reporting requirements imposed on regulated entities to achieve greater consistency. In particular, a materiality threshold should be introduced into the APRA requirements, and reporting processes and timeframes aligned.

Responsible person and officer requirements

A further area of inconsistency identified during consultations was between the 'responsible officer' requirements administered by ASIC and requirements imposed by APRA, including the 'responsible person' requirements in the proposed fit and proper prudential standards. Concerns raised with the Taskforce included differing:

- definitions of people covered by the requirements;

- tests and checks for determining fitness; and

- reporting requirements.

While recognising that divergences in the responsible officer and person regimes partly reflect the differing policy objectives of APRA and ASIC, the Taskforce considers there is some scope to streamline aspects of the regimes. In particular, consideration should be given to increasing the use of information, such as police checks, gathered for one process to be used in the other.

Corporate governance requirements

Industry stakeholders also raised concerns about corporate governance requirements. While ASIC and the Australian Stock Exchange have primary carriage of corporate governance regulation, APRA is developing a corporate governance prudential standard and has been consulting with industry stakeholders. There is widespread concern about the potential for duplication and inconsistency.

The Taskforce acknowledges these concerns. This review has demonstrated the risks of additional complexity and compliance burdens arising from duplication and inconsistency when multiple regulators set requirements in the same area.

The Taskforce's view is that if APRA considers it necessary to impose regulation in this area, it should have regard to the principles underpinning the Australian Stock Exchange Corporate Governance Council regime and incorporate a similar level of flexibility. The Taskforce considers that the requirements should be implemented flexibly to ensure arrangements can be tailored to individual entities. There should also be scope to update the requirements to reflect contemporary corporate governance practices. The Taskforce also notes APRA's commitment to industry in October 2005 that the corporate governance prudential standard will no longer require entities to make performance assessments of senior managers and directors available to APRA. This was a specific issue that generated significant concern among industry stakeholders.[207]

[207] Australian Government, *Rethinking Regulation: Report of the Taskforce on Reducing the Regulatory Burdens on Business*, January 2006, Chapter 5 – Economic and Financial Regulation, especially pp. 95 100 at http://www.regulationtaskforce.gov.au/finalreport/regulationtaskforce.pdf (accessed 8 August 2006).

Attachment 2 – US Congressional Research Service Summary of US Pension Protection Act 2006[208]

H.R.4
Title: To provide economic security for all Americans, and for other purposes.
Sponsor: Rep Boehner, John A. [OH-8] (introduced 7/28/2006) Cosponsors (4)
Related Bills: H.RES.966, H.R.2830
Latest Major Action: 8/14/2006 Presented to President.

SUMMARY AS OF: 7/28/2006--Introduced.

Pension Protection Act of 2006 - Amends the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code to establish new minimum funding standards for single-employer and multiemployer defined benefit pension plans.

Extends interest rate rules for the funding standard account that require the use of a rate based on long-term investment grade corporate bonds rather than 30-year Treasury securities. Amends the interest rate calculation for lump sum distributions.

Requires single-employer plans that are fully-funded to pay variable-rate premiums to the Pension Benefit Guaranty Corporation (PBGC). Sets forth alternative funding rules for commercial passenger airline defined benefit plans.

Sets forth requirements related to funding notices that must be provided by defined benefit plans.

Allows fiduciary advisers of a plan to give investment advice to participants or beneficiaries if certain requirements are met.

Sets forth rules that govern whether plans fail to meet requirements that prohibit age discrimination in defined benefit pension plans.

Increases deduction limits for single-employer and multiemployer plans. Makes permanent provisions from the *Economic Growth and Tax Relief Reconciliation Act of 2001* related to individual retirement accounts and pensions. Allows annuity contracts and life insurance contracts to include long-term care

[208] Source US Library of Congress THOMAS system at http://thomas.loc.gov/cgi-bin/bdquery/z?d109:HR00004:@@@D&summ2=m& (accessed 17 August 2006)

insurance contracts. Amends provisions governing the benefits of tax court judges.

Requires defined contribution plans holding publicly traded securities to provide employees with: (1) the opportunity to divest employer securities; and (2) at least three investment options other than employer securities. Allows employers to automatically enroll employees in defined benefit plans.

Sets forth provisions governing the division of pension benefits upon divorce.

Authorizes the Secretary of the Treasury to establish or change the Employee Plans Compliance Resolution System and any other employee plans correction policies.

Prohibits reduction of unemployment compensation as a result of pension rollovers.

Amends the Internal Revenue Code to modify provisions related to charitable contribution, tax-exempt organizations, and supporting organizations.

Amends the Economic Growth and Tax Relief Reconciliation Act of 2001 to permanently extend qualified tuition program provisions.

Miscellaneous Trade and Technical Corrections Act of 2006 - Amends the Harmonized Tariff Schedule of the United States to adjust the duty for certain chemicals, textiles, household and sporting goods, electronics, food, equipment and other items. Authorizes to President to adjust the Tariff Schedule as necessary to carry out certain CAFTA amendments.