Parliamentary Joint Committee on Corporations and Financial Services

The structure and operation of the superannuation industry

August 2007

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Duties of the Committee

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the Parliamentary Committee's duties as follows:

(a) to inquire into, and report to both Houses on:

(i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

Terms of Reference

On 30 June 2006, the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into the structure and operation of the Superannuation Industry (Supervision) Act 1993 and the superannuation industry to ensure that it provides an efficient, effective and safe regulatory structure for the management of superannuation funds, with particular reference to:

1. Whether uniform capital requirements should apply to trustees.
2. Whether all trustees should be required to be public companies.
3. The relevance of Australian Prudential Regulation Authority standards.
4. The role of advice in superannuation.
5. The meaning of member investment choice.
6. The responsibility of the trustee in a member investment choice situation.
7. The reasons for the growth in self managed superannuation funds.
8. The demise of defined benefit funds and the use of accumulation funds as the industry standard fund.
9. Cost of compliance.
10. The appropriateness of the funding arrangements for prudential regulation.
11. Whether promotional advertising should be a cost to a fund and, therefore, to its members.
12. The meaning of the concepts “not for profit” and “all profits go to members.”
13. Benchmarking Australia against international practice and experience.
14. Level of compensation in the event of theft, fraud and employer insolvency.
15. Any other relevant matters.

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Executive Summary

Introduction

Since 1987 Australia has had a system of mandatory superannuation contributions. The level of superannuation contributions an employer is required to provide on behalf of employees is prescribed under some federal and state industrial awards and the Commonwealth's superannuation guarantee (SG) scheme. The introduction of the SG was accompanied by reform of the prudential framework governing superannuation. The *Superannuation Industry (Supervision) Act 1993* (SIS Act) and supporting regulations came into effect in July 1994. The SIS Act remains the dominant legislative instrument setting prudential standards and protecting superannuation fund members' interests.

In early 2007 total superannuation assets reached the $1 trillion mark, backed by strong equity markets and a guaranteed flow of money that some researchers estimate could double in size by 2015. This was up from $761.9 billion in June 2005 and four times the value of superannuation assets in June 1995. The significant growth in the level of superannuation savings over the past decade should be viewed in the context of government attempts to introduce choice and portability of superannuation and widen the eligibility criteria for low income earners to receive the government co-contribution.

Choice of Fund has been a central part of the national agenda to increase the level of retirement savings since 1996. The committee acknowledges and supports the principle of people having the freedom of choice of both superannuation fund and investment options, provided there is appropriate prudential regulation and licensing to ensure people are protected from unwarranted risk. The committee believes that in the long run (and with appropriate safeguards in place) choice will increase competition, resulting in efficiencies and improved returns on superannuation savings.

Regulatory framework and international benchmarks

A common thread running through evidence from peak industry associations and other stakeholders is that the laws and regulations governing superannuation have become too complex, onerous and conflicting in some instances and have not kept pace with industry developments. Some in the industry expressed the view that the legislation is repetitive, clumsy, ambiguous, and contains unnecessary definitions. There were calls for comprehensive change to improve the law.

The committee shares these concerns. It believes that the legislation needs to be as clear and concise as possible and fit the current policy environment for superannuation. Above all, it should provide an efficient and effective environment for the investment and management of members' funds. The complexity and length of the legislation and the fact that it has been subject to persistent and frequent change, has made it difficult to master.

In the light of industry concerns about the complexity of the SIS Act, the committee recommends that the government undertake a comprehensive review of the laws and regulations governing superannuation to identify how they may be rationalised and simplified. The review should be carried out by Treasury.

The committee also looked to overseas jurisdictions, especially the United Kingdom and the United States, to see if they shed any light on Australia's superannuation industry. The lack of any internationally agreed benchmarks suggests that it is difficult to compare Australia's compulsory, privately managed and prudentially regulated system with the wide variety of systems operating in other countries. Be that as it may, the committee finds that while few in the industry openly contest the view that Australia has a world class retirement income system that is the envy of many other countries, this does not mean that other systems have nothing to offer or that the government and the industry cannot learn from overseas developments.

The committee recommends that APRA, in consultation with peak superannuation bodies and academics in particular, undertake empirical research on the strengths and weaknesses of superannuation systems operating in other OECD countries in order to develop a framework for benchmarking Australia's superannuation system against international best practice.

Promotional advertising and third party transactions

Issues pertaining to the reporting requirements of superannuation funds are examined in Chapter 3. These include whether expenditure on promotional advertising complies with the sole purpose test and should be disclosed to fund members, use of the term 'not for profit' by industry funds in the context of third party transactions with service providers and the propriety and transparency of these relationships, and concerns about inefficiencies and cost associated with regulatory overlap.

Promotional advertising is an inevitable consequence of superannuation funds competing for business, which was one of the main objectives of the government's Choice of Fund legislation. Industry support for trustees to use member funds to advertise was widespread. It was argued that promotional advertising plays a positive role in educating members about the features of their fund, assists in retaining or attracting new members, and results in economies of scale.

The committee believes that APRA and the superannuation industry should strive to find common ground in compulsory and specific disclosure by funds of expenditure on advertising and promotion. The committee can see a potential application of Australian Accounting Standards Board (AASB) standards to the superannuation industry. Although the AASB has not yet considered the accounting treatment and disclosure of promotional advertising by superannuation funds, it expects to do so sometime in the future. The committee recommends that peak superannuation bodies and APRA work with the AASB to form appropriate compulsory accounting and disclosure by all funds for promotional advertising, sponsorship expenses and executive remuneration.

The committee considered whether industry funds' use of the phrase 'not for profit' is legitimate in the context of contractual arrangements with service providers. The key issue relates to the propriety and transparency of these arrangements, in particular related party arrangements where a competitive tendering process for service provision has not been undertaken. While the committee agrees with ASIC that use of the 'not for profit' label by itself is not misleading as a consequence of payments to third party service providers, the more significant issue is whether members are getting a reasonable deal on these transactions, they are conducted at arms length and overpricing is not occurring.

The committee received no evidence of impropriety in relation to related party service agreements. However, the decision by Industry Super Network not to provide answers to any questions it agreed to take on notice was unhelpful and therefore fails to allay concerns about the cost of third party transactions with service providers. The committee is concerned that fund members cannot be fully informed when investing superannuation savings if industry funds do not disclose the true cost involved in their administration. This is why the committee recommends that the government develop an effective disclosure policy to address deficiencies in reporting related party transactions, and that trustees of superannuation funds publicly tender key service provision agreements.

Member investment choice

The committee considered whether superannuation savings are safeguarded under the existing prudential framework, and whether potential risks to savings are adequately addressed in the current regulatory environment. Chapter 4 examines this issue through the lens of member investment choice and the role of the trustee. The committee focused on criticisms of APRA's interpretation of investment choice and a strongly held industry view that further regulatory clarity is needed on the role of the trustee.

There is widespread agreement that the trustee's responsibility in a member investment choice situation should be to its core statutory duties, including to act in the best interests of all members, implement the fund's investment strategy in accordance with the SIS Act and ensure proper disclosure. However, this gives rise to different interpretations of law and policy. While investment choice is ultimately the member's decision, the dividing line between the trustee's and member's responsibility may be legally unclear.

There is concern that APRA's interpretation may prevent trustees from offering real investment choice to those members who want it. This was balanced by evidence from APRA and Treasury that member investment choice is not unlimited choice. Trustees are not permitted to allow an individual member's investment choice if that would not be suitable for the fund as a whole.

A widely held view in the industry is that APRA's written guidance and the legal advice on which it is based appear to have created more uncertainty for some trustees

and their advisers, not less. However, the committee finds that this uncertainty reflects an underlying systemic problem, which is that the SIS Act has not kept pace with industry developments, government policy or even community standards.

Be that as it may, a strong case was made for APRA to clarify the trustees' specific obligations under the SIS Act in order for it to better accommodate the existence of member investment choice. The committee recommends that APRA release its legal advice on the role of the trustee in a member investment choice situation and consult further with industry to clarify the duties of trustees that offer member investment choice. It recommends that APRA review its written guidance and further clarify its interpretation of the role of the trustee to ensure that the reality of investment choice and the obligations of trustees under the SIS Act are better integrated. The committee also recommends that funds should be permitted to provide simple, standard advice to members at their request about the appropriateness or otherwise of non-standard default investment options within the fund.

Safeguarding superannuation savings

Another theme examined by the committee is the importance of trustees addressing operational and governance risks before a fund experiences major difficulties that could threaten members' savings. The superannuation industry has placed a great deal of emphasis on prevention, which is a major premise of the current trustee licensing system. A number of issues fall under the umbrella theme of safeguarding superannuation. These include capital requirements and unit pricing, APRA's standards, funding arrangements for prudential regulation, compensation arrangements, and lost superannuation and portability.

The superannuation industry on the whole is opposed to the introduction of uniform or universal capital requirements. There is widespread agreement that any change to the existing rules on capital adequacy for trustees of superannuation funds is unnecessary and inappropriate and is unlikely to bring additional benefits to fund members. Evidence from industry funds highlighted that APRA licensing has imposed a uniform and comprehensive system of risk management across all superannuation funds, requiring funds to demonstrate the adequacy of their resources.

The accuracy and method of fund asset valuation is critical to the integrity of the investment process and ultimately investor confidence. A strong case was made for a mandatory unit pricing methodology for public offer funds. Fund choice and portability rules have contributed to inter-fund membership flows, which increases the need for funds to accurately price members' savings. The committee agrees that unit pricing is the most appropriate way to allocate investment earnings and appears to be the best way to ensure equity for members who move between funds. The committee recommends that the government mandate a uniform unit pricing methodology for all public offer superannuation funds, including any necessary transitional arrangements. It also recommends that where unit pricing is utilised improved operational risk parameters are identified and implemented by APRA.

The committee accepts that there must be accountability to ensure that revenue collected from superannuation funds to pay for the regulation of the industry is matched as closely as possible to the actual cost of supervision. The committee finds that current funding arrangements ensure transparency, relative equity and ease of administration by APRA. The committee does not believe another review of the levy issue is warranted at this point in time.

The committee accepts that it is impossible for the superannuation industry to completely insulate itself against the fraudulent activities of unscrupulous operators. A high degree of community confidence in the compulsory superannuation system is nevertheless important. The committee finds that existing compensation arrangements for theft and fraud are sufficiently robust to deal with instances of criminal activity. The committee is comfortable with the current levy arrangements, the amount of which is determined after an event has occurred. The committee believes that a so-called 'pre-event' levy would be difficult to determine and could potentially impose unacceptably high costs on the industry.

Portability and consolidation have become increasingly important issues for fund members under the Super Choice regime. The committee is concerned at anecdotal evidence that some funds are deliberately slowing the process of transferring funds and placing administrative hurdles in the path of fund members. It encourages APRA to be conscientious in enforcing the new 30 day limit on funds transfers. The committee also heard evidence of the potential for exit fees to undermine competition. The committee recommends prohibiting prospectively all exit fees that exceed the administrative cost of transfer.

The committee notes that there are 30 million superannuation accounts currently in existence, which is an average of 3 per employed person. The committee is concerned that of these some 5.7 million are lost accounts containing almost $10 billion. This represents a major structural weakness and inefficiency in the superannuation system that requires an active default solution. The committee expects lost superannuation will remain a real problem for large numbers of members. Good data collection and reporting by regulators and funds will be essential in order to devise further relieving strategies in the future. The committee recommends that where a tax file number is attached to a lost account it should be automatically consolidated or rolled together into a member's last active account using the tax file number system.

Financial advice

The central issue raised in evidence relates to the role of financial advice. Legislative barriers to cost-effective advice and how to overcome them in order to find a balance between consumer protection and accessibility of advice are examined in Chapter 6. How advisers are remunerated and debate over conflicts of interest associated with commission-based remuneration models are the focus of chapter 7.

Cost and accessibility

The advent of Super Choice and the autonomy it provides superannuation fund members have drawn attention to the role of funds and professional advisers in helping consumers navigate their way through the options they now face. The committee finds that most fund members will not seek individually tailored financial advice on superannuation, particularly on choosing their own investment strategy. A combination of apathy, inertia and a perception of those with low or moderate fund balances that the cost and effort would not justify the benefits are the principal reasons. Also important is a belief that the fund managers are experts and will do a good job. While the committee acknowledges that there is merit in the argument that all members would benefit to some extent from personal guidance on superannuation, the reality is that people cannot be coerced into taking such an active role in managing their superannuation affairs.

There was broad consensus over the inadequacy of current regulatory arrangements for the provision of basic, limited advice on superannuation. Criticism of the legislative framework for the provision of financial advice focused on the breadth of the definitions of 'financial product advice'. It was argued that definitions have restricted fund members' access to advice on issues where consumer protection should not, on the face of it, be a serious concern. Reforms to protect consumers have captured too many advice situations to the detriment of accessibility.

The committee considered possible remedies to enable the legislative framework to achieve greater proportionality between consumer protection and accessibility of advice. The committee supports the government's proposed measure to exempt advisers from providing a Statement of Advice where personal advice is provided that does not involve recommending a product or remuneration for the advice. The proposal to introduce a threshold for disclosure on a superannuation investment of less than $15,000, where the advice recommends consolidating investments or making additional contributions, is also supported by the committee. The committee recommends further regulatory guidance to remove uncertainty associated with funds communicating with their members. The objective is to enable funds to provide targeted information to different categories of membership and provide benefit projections to their members.

Other remedies considered by the committee relate to the regulation of accountants and product disclosure information. The committee does not believe accountants should be exempt from holding an AFS licence when providing financial product advice. However, the committee recommends that accountants be able to advise clients on altering their superannuation contribution levels and consolidating superannuation investments into an existing fund, without requiring an AFS licence.

The readability of disclosure material is vital for consumers to be able to readily access information and advice on superannuation. Unfortunately, this is seldom the case as most product disclosure statements (PDS) are too long and complex and unsuitable for general consumption. While the industry agrees that consumers would

benefit greatly from shorter, more comprehensible and comparable product disclosure statements, the means to achieve this are in dispute.

The committee believes that the readability of PDS' could be improved by ensuring important information is prominently displayed, in summary form, at the front of the document. This would enable a comparison between products to be made without the need for the entire document to be read. The committee strongly encourages superannuation product issuers to improve their PDS' in this fashion. If this cannot be achieved by the industry of its own volition it should be mandated by government. The committee recommends that the government conduct market research on the readability of superannuation with the goal to introduce simple, standard, readable documentation.

Remuneration, education and financial literacy

The effect of different remuneration models on the standard of superannuation advice was a major issue raised during the inquiry. The committee considered evidence in relation to potential conflicts of interest in commission-based remuneration models, payment of ongoing trailing commissions and use of approved product lists and 'tied' adviser relationships. The committee considered possible remedies to improve the quality of superannuation advice, including banning commissions and shelf fees, improving disclosure of conflicts of interest, mandating a higher standard of advice and facilitating the provision of fee-for-service advice.

The committee accepts the view that commission-based remuneration generates conflicts of interest for advisers that can lead to inappropriate advice, as demonstrated by ASIC through its shadow shopping survey. Furthermore, trailing commissions potentially lead to significant sums being paid to advisers throughout the life of a financial product without a commensurate return in the form of ongoing superannuation advice.

However, the committee does not recommend the prohibition of commissions on superannuation products, as argued by industry funds. Many consumers cannot afford to pay for up front fee-for-service advice on their superannuation. This situation is compounded by the unresolved problem that the current disclosure regime causes advice to cost more than its inherent value. Furthermore, banning commissions will not remove all potential conflicts of interest in the industry. Superannuation funds, including industry funds, have other remuneration practices such as bonuses and incentive plans for sales people that may give rise to conflicts.

The committee is more concerned about the effect of shelf fees. Shelf fees can be anti-competitive and may encourage products to be listed and subsequently recommended that may not be in the best interests of the client. Unlike commission-based remuneration, shelf fees cannot be said to facilitate access to advice by making it more immediately affordable to those without discretionary funds to pay up-front fees. As the industry is progressively moving from commission-based to fee-based advice fees, so it should move from shelf fees to a more competitive means of meeting the cost of product listings. Ultimately, the industry should move towards fees for advice,

payment for funds management and payment for administrative services. The committee recommends that ASIC work with the industry to provide investors more effective and detailed disclosure of shelf fees.

The disclosure of conflicts of interest needs to be more effective to ensure consumers are better able to measure their likely effect on the quality of advice they receive. The committee believes that disclosure must be effective and meaningful rather than a perfunctory process undertaken to comply with legislative requirements. However, the committee does not support a proposal to raise the threshold of the standard of financial product advice from 'appropriate' to 'best'. The reality of providing financial advice within the constraints imposed by approved product lists renders this an unobtainable objective.

The committee is of the opinion that disclosure will not be effective unless the nomenclature attached to financial advisers accurately conveys to consumers the adviser's relationship with, and interest in, the superannuation products they recommend. Accordingly, the committee recommends that the government should investigate the most effective way to develop with the industry appropriate nomenclature where the product recommendation advice available to consumers is limited by sales imperatives.

The committee is concerned about insufficient transparency with regard to the relationship between advisers, their licensees and superannuation product providers. It is apparent clients may not be aware of the integration of superannuation product supply and sales advice and the incentives that stem from such an arrangement. The committee, therefore, recommends that financial advisers should be required to disclose the ownership structure of the licensee he or she is operating under.

Arming consumers with the skills to interpret the quality and independence of the advice they receive is a priority issue. The shift from passive superannuation investments in which employers bore investment risk, to today's competitive market in superannuation products where investment risk is transferred to employees, has left consumers more vulnerable to the vagaries of the marketplace than previously. This transfer of risk has left superannuation fund members with the responsibility for taking decisions that were previously not required of them. As such, measures need to be taken to enable consumers to adapt to their new responsibility.

The committee believes this challenge can effectively be addressed by improving the accessibility of advice for those already in the system, from funds and licensed financial advisers, and ensuring that future fund members are provided with appropriate guidance during their school years. The committee notes with approval the government's Better Super television and radio advertisements designed to inform and educate people about the reforms to superannuation that came into effect on 1 July 2007. The committee also supports the government's Financial Literacy Foundation initiatives and recommends that they be reviewed when their effectiveness is able to be measured against clear performance benchmarks.

Self-managed superannuation funds

Self-managed superannuation funds are a significant part of the Australian superannuation landscape. They have become an increasingly popular way for people to hold retirement savings. The SMSF sector accounts for over 99 per cent of the total number of superannuation funds and represents 23 per cent of total superannuation savings.

The committee finds there is general agreement in the industry as to the reasons for the dramatic rise in the number of SMSFs. Self-managed funds enable members to control their investments, earn higher returns and diversify their assets. The popularity of SMSFs is also attributed to the absence of fees charged by professionally managed superannuation funds, the ability to invest in assets not otherwise available in a regulated fund and the provision of advice from accountants and financial planners.

The committee considered a number of regulatory and compliance issues associated with SMSFs. Trustees residing overseas for periods in excess of two years risk having their fund deemed non-complying, on the basis that the active member test for an Australian superannuation fund requires a resident active member's accumulated benefit to be greater than 50 per cent of the total accumulated benefit for all active members. The committee finds that the active member test is unnecessary because its objectives are met by other applicable laws and recommends that it be removed from the definition of an Australian Superannuation Fund.

The wisdom or otherwise of imposing a minimum balance on the operation of SMSFs was raised in evidence. The committee sees problems with the imposition of a statutory viability limit, particularly in light of its likely effect on younger investors. The highly individualised advice provided by accountants and financial advisers is an appropriate safeguard for investors seeking to establish an SMSF without viable seed funding. The committee, therefore, makes no recommendation in regard to minimum thresholds.

The committee heard evidence that the current limit of four individuals who can own and manage a SMSF should be increased in response to the prevalence of family businesses and funds that operate over two or more generations. It appears that the problem that exists now, on whatever scale, particularly affects funds seeking to operate across multiple generations, as well as co-owners of small businesses seeking to invest together. The effect of this restriction is likely only to worsen in the future, and should be addressed sooner rather than later. The committee recommends that the ATO consider raising the maximum number of trustees for any one SMSF from four to ten, in line with current and future demand.

In relation to the regulation of SMSFs, the committee accepts the argument that greater reliance should be placed on safeguards offered by accountants as the key interface between members and the regulatory and compliance system. In view of the current and future growth of SMSFs, it is important to ensure that the right balance is struck to minimise the regulatory burden of administration while also maintaining

financial and legal integrity. The committee recommends that SMSFs run by qualified accountants be audited annually for three years from their commencement and, subject to no irregularities, thereafter every five years.

The ability of recognised accountants that hold appropriate qualifications to provide advice to their clients on a decision to acquire or dispose of an interest in an SMSF, without the need to be licensed under financial services regulation, was a central issue raised in evidence. Consistent with its findings and recommendations from previous inquiries, the committee supports the argument by peak accounting bodies that the exemption should be extended to include general structural advice on all superannuation funds. The committee recommends that the exemption be broadened to enable accountants to provide advice on the structure of superannuation funds, rather than being limited to advising on SMSFs.

Recommendations

Recommendation 1

2.15 The committee recommends that APRA expand the information provided in its quarterly superannuation statistics to include a regular representative survey of the level of additional contributions above the 9 per cent superannuation guarantee from both employer and employee (salary sacrifice) and other forms of contribution. This should include analysis by income level and gender.

Recommendation 2

2.34 The committee recommends that Treasury conduct a review of the laws and regulations governing superannuation to identify how they may be rationalised and simplified.

Recommendation 3

2.66 The committee recommends that APRA, in consultation with peak superannuation bodies and academics in particular, undertake empirical research on the strengths and weaknesses of superannuation systems operating in other OECD countries, and that the findings be made publicly available. The aim is to develop a framework for benchmarking Australia's superannuation system against international best practice.

Recommendation 4

3.35 The committee recommends that peak superannuation bodies and APRA continue to work with the Australian Accounting Standards Board with a view to forming appropriate compulsory accounting and disclosure by all funds for promotional advertising, sponsorship expenses and executive remuneration.

Recommendation 5

3.64 The committee recommends that the government formulate and implement an effective disclosure policy for both product disclosure statements and annual reports to address any deficiencies in reporting related party transactions.

Recommendation 6

3.65 The committee recommends that trustees of superannuation funds publicly tender key service provision agreements.

Recommendation 7

3.95 The committee recommends that the government's proposed measures to simplify breach reporting be implemented through legislation.

Recommendation 8

3.97 The committee recommends that Treasury examine and report to government on the issue of overlapping, inconsistent and conflicting requirements of superannuation funds from a number of regulators.

Recommendation 9

4.58 The committee recommends that APRA make available for public scrutiny any legal advice it has received on the role of the trustee in a member investment choice situation, as a starting point for further industry consultation to clarify the duties of trustees of funds that offer member investment choice.

Recommendation 10

4.59 The committee recommends that APRA, in consultation with the superannuation industry, review Superannuation Circular II.D.1 to clarify its interpretation of the role of the trustee in a member investment choice situation. The committee further recommends that APRA ensure that its written guidance better integrate the reality of investment choice and the obligations of trustees under the SIS Act.

Recommendation 11

4.60 The committee recommends that superannuation funds be permitted as part of reform to the disclosure regime to provide simple, standard advice to members at their request about the appropriateness or otherwise of non-standard default investment options within the fund.

Recommendation 12

5.26 The committee recommends that superannuation funds improve the disclosure of their capital backing and/or the risk protection of capital and that APRA assist the industry with the development of disclosure of risk management systems to protect superannuation investors' funds.

Recommendation 13

5.33 The committee recommends that the government mandate a uniform unit pricing methodology for all public offer superannuation funds, including any transitional arrangements. The committee also recommends that where unit pricing is utilised improved operational risk parameters are identified and implemented by APRA.

Recommendation 14

5.70 The committee recommends that the government examine whether employee salary sacrifice should be paid by the employer at a minimum at the same time as the compulsory SG, and whether employer SG contributions should be paid on the pre-salary sacrifice income.

Recommendation 15

5.84 The committee recommends that exit fees that exceed the administrative cost of transfer should be prohibited prospectively.

Recommendation 16

5.105 The committee recommends that where a tax file number is attached to a lost account it should be automatically consolidated or rolled together into a member's last active account using the tax file number system. The member should have the right to opt out of the system if they wish. This automatic system

should not apply to a defined benefit account or an account with a significant exit fee.

Recommendation 17

6.110 The committee recommends that ASIC provides guidance to superannuation funds on the provision of targeted communication to separate categories of fund members, so called limited advice, without triggering the need for a statement of advice.

Recommendation 18

6.114 The committee recommends that ASIC consult further with superannuation funds on the provision of online calculators. Following this process ASIC should provide additional regulatory relief that will better enable funds, without undermining consumer protection imperatives, to use the generic calculator exemption to provide benefit projections for their members.

Recommendation 19

6.118 The committee recommends that ASIC should provide accountants with relief from holding an AFS licence in circumstances where they advise clients to alter their superannuation contribution levels or consolidate their superannuation investments into an existing fund.

Recommendation 20

6.146 The committee recommends that the government conduct market research on the readability of superannuation product disclosure statements with the goal to introduce simple, standard, readable documentation.

Recommendation 21

7.96 The Committee recommends that ASIC work with the industry to provide to investors more effective and detailed disclosure of shelf fees.

Recommendation 22

7.142 The committee recommends that the government consult with the superannuation industry with a view to reducing, with appropriate limitations, the constraints imposed by the sole purpose test on the payment of up front fees for financial advice from superannuation accounts.

Recommendation 23

7.146 The committee recommends that the government investigate the most effective way to develop with the industry appropriate nomenclature where the product recommendation advice available to consumers is limited by sales imperatives.

Recommendation 24

7.148 The committee recommends that ASIC should release a policy statement mandating that financial advisers disclose the ownership structure of their licensee when making a superannuation product recommendation.

Recommendation 25

7.170 The committee recommends that the government conduct a review of its Financial Literacy Foundation initiatives when their effectiveness is able to be measured against clear performance benchmarks.

Recommendation 26

8.21 The committee recommends that the active member test be removed from the definition of an Australian Superannuation Fund.

Recommendation 27

8.23 The committee recommends that fund members be able to draw superannuation pensions 'in specie', in line with existing provisions for lump sum payments.

Recommendation 28

8.36 The committee recommends that the ATO consider raising the maximum number of trustees for any one SMSF from four to ten, in line with current and future demand.

Recommendation 29

8.37 The committee recommends that a simple and clear alert warning should be provided to all trustees of an SMSF on their duties and responsibilities, the recommended ASIC minimum maturity figure and the absence of part 23 compensation in the event of theft and fraud.

Recommendation 30

8.45 The committee recommends that SMSFs run by qualified accountants be audited annually for three years from their commencement and, subject to no irregularities, thereafter every five years. SMSFs found to be non-compliant are to be audited annually for three further years.

Recommendation 31

8.61 The committee recommends that the accountants' exemption be broadened in keeping with its previous recommendation 1 to amend subregulation 7.1.29A. This would enable accountants to advise clients on the structure of any superannuation fund, rather than being limited to advising on the structure of self-managed funds only.

List of abbreviations

AASB	Australian Accounting Standards Board
ABA	Australian Bankers Association
ACCC	Australian Competition and Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ACTU	Australian Council of Trade Unions
AFA	Association of Financial Advisers
AFS	Australian Financial Services
AIR	Association of Independent Retirees
AIST	Australian Institute of Superannuation Trustees
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
ATO	Australian Tax Office
DB	defined benefit
DC	defined contribution
ERF	Eligible Rollover Fund
FPA	Financial Planning Association of Australia
FSG	Financial Services Guide
FSR	financial services reform
GEERS	General Employee Entitlements and Redundancy Scheme
ICAA	Institute of Chartered Accountants in Australia
IFF	Industry Funds Forum
IFS	Industry Funds Services

IFSA	Investment and Financial Services Association
IOPS	International Organisation of Pension Supervisors
ISN	Industry Super Network
LMR	Lost Members Register
MOU	Memorandum of Understanding
OECD	Organisation for Economic Cooperation and Development
PASL	Professional Associations Superannuation Limited
PDS	product disclosure statement
RBA	Reserve Bank of Australia
RCSA	Recruiting and Consulting Services Australia
RSE	Registrable Superannuation Entity
SoA	Statement of Advice
SG	superannuation guarantee
SIS Act	*Superannuation Industry (Supervision) Act 1993*
SMSF	self-managed superannuation fund
SPAA	Self-Managed Super Fund Professionals' Association of Australia
SWG	Superannuation Working Group
TFN	tax file number

Chapter 1

Introduction

Background

1.1 On 30 June 2006 the committee resolved to inquire into the structure and operation of the *Superannuation Industry (Supervision) Act 1993* and the superannuation industry to ensure that it provides an efficient, effective and safe regulatory structure for the management of superannuation funds. The committee agreed that it would examine the following terms of reference:

(a) Whether uniform capital requirements should apply to trustees.

(b) Whether all trustees should be required to be public companies.

(c) The relevance of Australian Prudential Regulation Authority standards.

(d) The role of advice in superannuation.

(e) The meaning of member investment choice.

(f) The responsibility of the trustee in a member investment choice situation.

(g) The reasons for the growth in self managed superannuation funds.

(h) The demise of defined benefit funds and the use of accumulation funds as the industry standard fund.

(i) Cost of compliance.

(j) The appropriateness of the funding arrangements for prudential regulation.

(k) Whether promotional advertising should be a cost to a fund and, therefore, to its members.

(l) The meaning of the concepts “not for profit” and “all profits go to members.”

(m) Benchmarking Australia against international practice and experience.

(n) Level of compensation in the event of theft, fraud and employer insolvency.

(o) Any other relevant matters.

Conduct of the inquiry

1.2 The inquiry was advertised in the *Australian* newspaper and on the internet. The committee invited written submissions from a wide range of industry stakeholders, government regulators, non-government organisations and academics. Details of the inquiry were placed on the committee's website.

1.3 Early during the inquiry, the committee requested the Parliamentary Library to prepare a research paper on term of reference 13, benchmarking Australia against international practice and experience. The paper that was issued in May 2007 provided a detailed comparison of relevant features of the retirement income systems of Australia, the United Kingdom and the United States. The committee agreed to make the paper publicly available on the inquiry website.

1.4 The committee held six public hearings: in Sydney on 24 October 2006 and 7 March 2007; in Melbourne on 25 October 2006 and 5 and 6 March 2007; and in Canberra on 20 November 2006. A list of witnesses who appeared at the hearings is at Appendix 2. Copies of the Hansard transcripts are available through the internet at http://www.aph.gov.au/hansard.

Committee's approach

1.5 The committee strongly endorses the view that the regulatory structure for superannuation should promote a viable industry that encourages fair competition to enable fund members to maximise their retirement savings in as safe and secure environment as possible. Above all, it should provide for an efficient and effective environment for investment and management of members' funds. This is why one of the committee's main objectives was to examine whether the current legislative and regulatory structures enable fund members to maximise their superannuation savings. As a leading publishing and research firm operating in the superannuation industry told the committee:

> Superannuation has fundamentally promised that, when I retire, there is going to be a big fat cheque waiting for me with lots of zeros on the end, so I have to be able to trust that the guys are going to be there to mail me that cheque.[1]

1.6 A major issue underpinning the inquiry's terms of reference is whether the regulatory framework for superannuation is adequate for the current needs of industry and the demands made by consumers. The committee believes that the legislation needs to be as clear, concise and effective as possible and fit the current policy environment for superannuation. Yet during the inquiry concerns were raised about the complexity of the SIS legislation and its ongoing relevance to an industry that is experiencing fundamental change. The introduction of Super Choice and member investment choice has shifted the responsibility for superannuation from employers to employees and commercial superannuation providers. The committee notes that there is now a much greater focus on individuals taking responsibility for their own retirement savings.

1.7 The committee agrees with the Investment and Financial Services Association (IFSA) that choice of fund legislation and licensing requirements for superannuation

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1 Mr Alex Dunnin, Executive Director, Rainmaker Information Pty Ltd, *Committee Hansard*, 24 October, Sydney, 2006, p. 77.

funds have changed how the superannuation system operates, creating an openly competitive environment for all superannuation providers and placing more demands on the legislative, regulatory and policy framework. These factors, together with increased fund disclosure and member responsibility for fund and investment selection, provide a regulatory picture that is very different from the one established in the early 1990s:

> The SIS Act has not been the subject of any significant review since its enactment, and the Parliament should ensure that the law and its administration is not out of step with current day requirements and developments, including technological and market developments over the last 12 years. While we consider that the current structural requirements for the regulation of superannuation are solid, the laws have not kept pace with industry changes and consumer demands. Maintaining the current laws may challenge the efficiency and effectiveness of the superannuation market.[2]

1.8 It is in the context of individual choice that refinements to financial services reform (FSR) legislation, that have focused on product disclosure, transparency and consumer protection, have become increasingly important. Yet the industry is concerned that FSR has added another layer of compliance obligations on funds and associated entities without sufficient compensating market or consumer benefits, giving rise to calls for simplification and further refinements. The committee heard how the level of regulation and red tape for product disclosure applying to all funds under FSR legislation is considerably greater than it was ten years ago.[3] The particular concern with FSR mainly related to the lengthy, complex and generally unreadable disclosure documentation that is issued to consumers.

Report structure and chapter summary

1.9 The report consists of 8 chapters. Chapter 2 provides background on the regulation of the superannuation industry and describes industry trends that have resulted in total superannuation savings in Australia exceeding the $1 trillion mark. Chapter 3 examines issues that relate to the reporting requirements of superannuation funds. These include whether promotional advertising complies with the sole purpose test and whether funds are properly disclosing to their members expenditure on advertising; use of the term 'not for profit' by industry funds in the context of third party transactions with service providers and the propriety and transparency of these relationships; and complaints about the inefficiencies and cost associated with regulatory overlap.

1.10 Chapter 4 addresses the issue of member investment choice and the debate over the role of the trustee and APRA's interpretation of law and policy in this area.

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2 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, 24 October 2006, Sydney, p. 90.

3 Mr Frank Gullone, Chief Executive Officer, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 18.

Chapter 5 examines issues under the umbrella theme of safeguarding superannuation savings. These include capital adequacy, uniform capital requirements and unit pricing; the relevance of APRA standards; current funding arrangements for prudential regulation; compensation arrangements in the event of theft and fraud and employer insolvency; portability and exit fees; and 'lost' superannuation.

1.11 Chapters 6 and 7 address arguably the central issue raised in evidence during the inquiry: the role of financial advice. Chapter 6 examines legislative barriers to cost-effective advice and how to overcome them in order to find a balance between consumer protection and accessibility of advice. Chapter 7 continues the theme of financial advice by examining how advisers are remunerated, especially concerns about conflicts of interest associated with commission-based remuneration models. It also discusses the important role of education and financial literacy programs in enabling both existing and new fund members to navigate the complex superannuation environment.

1.12 Chapter 8 examines the reasons for growth in the number of self-managed superannuation funds and issues relating to the administration, regulation and future viability of this industry sector.

Acknowledgements

1.13 The committee thanks those organisations and individuals who made submissions to the inquiry, gave evidence at the public hearings and provided the committee with additional information and responses to questions taken on notice. The committee also thanks Mr Leslie Nielson from the Parliamentary Library for preparing a detailed research paper and assisting the committee in its deliberations on term of reference 13.

Chapter 2

Prudential framework, industry trends and benchmarking international practice

Background

2.1 Since 1987 Australia has had a system of mandatory superannuation contributions. The level of superannuation contributions an employer is required to provide on behalf of employees is prescribed under some federal and state industrial awards and the Commonwealth's superannuation guarantee (SG) scheme. The scheme requires all employers to provide a minimum level of superannuation contributions in each financial year for employees.[1] From 1987 all employers were effectively required to contribute 3 per cent of ordinary time earnings to a regulated superannuation fund. The rate of contribution gradually increased to 9 per cent of wages in July 2002.

2.2 The compulsory SG scheme is one of three pillars of Australia's retirement income system which aims to achieve a higher standard of living in retirement than would be possible from the publicly-funded age pension alone. The other two components are the means-tested, taxpayer-funded, age pension and additional voluntary superannuation contributions usually via a salary sacrifice, spouse contribution or co-contribution scheme.[2] It is acknowledged that many people save outside of superannuation, including but not limited to home ownership.

2.3 The introduction of the SG was accompanied by reform of the prudential framework governing superannuation. The *Superannuation Industry (Supervision) Act 1993* (SIS Act) and supporting regulations, which came into effect in July 1994, replaced the *Occupational Superannuation Standards Act 1987*. The SIS Act remains the dominant legislative instrument setting prudential standards and protecting superannuation fund members' interests. Most superannuation contributions are made to funds (known as 'superannuation entities') that have elected to comply with the provisions of the act in order to obtain concessional tax treatment.

2.4 In 1996 the Government commissioned the Financial System Inquiry to undertake a major review of the financial services sector regulatory framework to ensure its continued effectiveness and efficiency. The report of that inquiry (the Wallis Report) made a number of recommendations that had significant implications for the structure of financial regulation.[3] In accepting many of the report's

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1 *Superannuation ready reckoner: taxation and preservation rules for 2004-05—revised February 2005*, Research Brief no. 10, 2004-05, Department of the Parliamentary Library, 14 February 2005, pp. 8-9.

2 *An adequate superannuation-based retirement income?*, Research Brief no. 12, 2005-06, Department of the Parliamentary Library, 16 March 2006, p. 9.

3 Australian Financial System Inquiry, *Final Report* (Wallis Report), Canberra, AGPS, March, 1997.

recommendations, the government decided that the best regulatory structure for the financial services sector would involve two regulators: one responsible for the prudential regulation of any entity that needed to be prudentially regulated; the other responsible for market and disclosure regulation of any financial products being offered to consumers.

2.5 The 'twin peaks' model of regulation that the government eventually adopted created two highly specialised agencies – the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) – with clearly defined regulatory roles, or what ASIC Deputy Chairman, Mr Jeremy Cooper, described as a 'division along functional lines'.[4] Under the new regime, which came into effect on 1 July 1998, policymaking for prudential services moved to the Department of the Treasury, APRA became the new prudential supervisory body assuming responsibility for policy implementation, and ASIC assumed responsibilities for regulation, consumer protection for financial services and enforcement.[5]

2.6 The institutional framework covering superannuation has also been affected significantly by the *Financial Services Reform Act 2001* (FSR), which addresses disclosure and consumer protection for the entire financial services industry. The FSR Act amended the Corporations Act and ASIC Act to provide for a single licensing regime for financial sales, advice and dealings in relation to financial products; a consistent financial product disclosure regime; and a single authorisation procedure for financial exchanges and clearing and settlement facilities.

2.7 The remainder of this chapter examines how the regulation of the superannuation industry is structured, and describes a number of industry-wide trends that have seen superannuation savings across Australia rapidly increasing to unprecedented levels. The committee then makes a few preliminary observations regarding these broader structural issues and trends, taking into consideration the views of the superannuation industry raised in evidence to this inquiry.

Prudential regulation

2.8 Prudential regulation aims to promote prudential behaviour by financial institutions so as to ensure they will be able to meet their obligations to their depositors, policyholders or members. Its primary concern is the quality of regulated entities and their systems for identifying, measuring and managing business risk.[6]

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4 Mr Jeremy Cooper, *The integration of financial regulatory authorities – the Australian experience*, paper presented to the Securities and Exchange Commission of Brazil, 30th Anniversary Conference, Assessing the Present, Conceiving the Future, 4-5 September 2006, p. 3.

5 *Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services: First Report*, Senate Select Committee on Superannuation and Financial Services, August 2001, pp. 5-6.

6 Australian National Audit Office, *APRA's Prudential Supervision of Superannuation Entities*, Audit report No.6 2003-04, pp. 21-22.

Although the regulation and prudential supervision of the superannuation industry has undergone fundamental change over the past decade, a consistent objective underlying the regulatory system has been to increase superannuation savings and protect fund members' superannuation entitlements.[7]

2.9 The current prudential and disclosure framework applying to superannuation was established by the Government in 1998 as part of its response to the recommendations of the Financial System Inquiry. According to Treasury, the prudential framework has two principal aims of ensuring that:

- entities are managed prudently so that they are able to meet their financial obligations to consumers; and
- consumers are given adequate information and are kept informed of the nature and performance of their investments.[8]

2.10 Prior to the mid-1980s the superannuation industry was largely self-regulated. As a result of the dramatic increase in superannuation coverage and contributions in the late 1980s and early 1990s (as a result of the 1986 national wage case and the introduction of the SG) major reforms were undertaken in the regulatory framework. In 1987 the Insurance and Superannuation Commission was established as a specific industry regulator. This was followed in 1993 by the introduction of the SIS Act to regulate the compulsory employer superannuation schemes. The stated objective of the Act is contained in section 3:

> …to make provision for the prudent management of certain superannuation funds, approved deposit funds and pooled superannuation trusts and for their supervision by APRA, ASIC and the Commissioner of Taxation.

2.11 In addition to the SIS Act, the main pieces of legislation that regulate the superannuation industry are the *Corporations Act 2001* (Corporations Act) and associated regulations, and to a lesser extent the *Income Tax Assessment Act 1936*. The compulsory employer superannuation schemes are regulated by the SIS Act, which:

- establishes APRA and ASIC as the regulators of the Superannuation Retirement Industry;
- introduces statutory duties on trustees of such schemes;
- provides for disclosure of information to members;
- incorporates certain covenants into Trust Deeds;
- establishes a compensation mechanism for the protection of members of superannuation funds in the event of theft and fraud (self-managed funds are excluded);

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7 Productivity Commission, *Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, p. 9.

8 Treasury, *Submission 55*, p. 3.

- establishes wider reporting duties for auditors of superannuation schemes;
- provides full vesting of employer contributions for the employee;
- prohibits borrowing by funds;
- codifies the prudent person and sole purpose test; and
- includes a restriction on in house investment of 5 per cent.

Regulators

2.12 The superannuation industry is regulated by three bodies: APRA, ASIC and the Australian Tax Office (ATO). These are independent government agencies that are responsible for different aspects of the regulation of the superannuation industry.

2.13 The role of each is described in more detail below. A general distinction in relation to superannuation is that APRA is responsible for the prudential aspects of the SIS Act, promoting the stability and soundness of superannuation funds; ASIC is responsible more broadly for corporations, financial services and consumer protection; and the ATO regulates the activities of self-managed superannuation funds (SMSFs) and enforcement of SG payments. While each of the regulators is heavily involved in regulating entities, only ASIC attends to the needs of consumers and beneficiaries. In addition, Treasury has responsibility for formulating policy on the broad features of the retirement income system, prudential regulation and consumer protection.

Australian Prudential Regulatory Authority

2.14 Prudential regulation seeks to reduce the likelihood that regulated entities will fail and be unable to meet their contractual commitments. Governments around the world have imposed prudential controls in the financial services sector because of the critical role the sector plays in the financial security of society and in a modern market economy. Prudential regulation is designed to promote stability and soundness within the financial entities it supervises. To this end, the SIS Act imposes duties and obligations on trustees and provides APRA with supervisory and regulatory power. It also provides key data on a range of superannuation fund statistics.

Recommendation 1

2.15 The committee recommends that APRA expand the information provided in its quarterly superannuation statistics to include a regular representative survey of the level of additional contributions above the 9 per cent superannuation guarantee from both employer and employee (salary sacrifice) and other forms of contribution. This should include analysis by income level and gender.

2.16 APRA supervises complying superannuation funds worth approximately $808 billion, other than self-managed superannuation funds worth approximately $245 billion. However there is no prudential standard making power in respect of regulated superannuation entities. Further, APRA provides guidance on the manner in which it interprets and assesses compliance with the operating standards contained in the law

(for more on this issue see the discussion of member investment choice in Chapter 4). APRA issues circulars and guidance notes on its interpretation of the SIS Act, SIS regulations and related matters. APRA's guidance on superannuation is non-binding.[9] Nevertheless, in practice, particularly in the context of the re-licensing of all superannuation funds, APRA has or is in the process of implementing various guidance notes.

Australian Securities and Investments Commission

2.17 The Australian Securities and Investments Commission is responsible for administering and enforcing the Corporations Act, the *Australian Securities and Investments Commission Act 2001* and parts of the SIS Act as they apply to superannuation trustees and other financial service providers in the superannuation industry. The main role of ASIC is to regulate the activities of all corporate entities in Australia, including financial entities such as superannuation funds. From 1998 it became responsible for consumer protection in superannuation.

2.18 The ASIC submission described the regulator's main functions as:

- granting Australian Financial Services (AFS) licences and imposing and changing licensee conditions on superannuation trustees, advisers and other financial services businesses in the superannuation industry;
- maintaining public registers of, among other things, AFS licence holders and authorised representatives of AFS licence holders;
- issuing policy statements, guides, information sheets and answers to frequently asked questions to explain how the law works and compliance obligations;[10]
- modifying the application of many parts of the Corporations Act and SIS Act, and granting exemptions from some parts of the Corporations Act;
- monitoring how the superannuation industry complies with the law;
- enforcing the law by taking action against inappropriate advice about superannuation and misleading or deceptive and unconscionable conduct in relation to superannuation products and advice; and
- educating consumers in order to promote the confident and informed participation of investors and consumers in the financial system.[11]

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9 Australian Bankers' Association, *Submission 88*, p. 9.

10 From July 2007, ASIC rationalised and redesigned its regulatory documents to include consultation papers, regulatory guides, reports and information sheets. For details see 'ASIC''s Better Regulation: New Regulatory Documents and Road Map', Information Release IR 07-36, Thursday 5 July 2007.

11 ASIC, *Submission 48*, pp. 5-7.

Australian Tax Office

2.19 The Australian Tax Office is responsible for ensuring the effective management of assets invested in self-managed superannuation funds and SG compliance. Its main role is ensuring that SMSFs comply with the SIS Act and regulations. According to the ATO submission: 'Our focus is on whether fund investments are in accordance with trustees' stated investment strategies and in accordance with the SIS Act, but it is not our role to look at the overall soundness of the investments from a business perspective'.[12] It also pointed out that as more people with an SMSF retire from the workforce these funds are maturing into long term, intergenerational retirement vehicles.

Prudential framework

2.20 The Treasury submission identified four main elements that comprise the prudential regime for superannuation: the trust structure, minimum entry requirements (licensing), the sole purpose test, and investment management requirements. A brief summary of the first three elements is provided below. The investment obligations on trustees under the SIS Act are examined as part of the committee's consideration of member investment choice in Chapter 4.

Trust structure

2.21 Regulated superannuation entities generally operate under a trust structure for the benefit of members and beneficiaries. The assets of the superannuation entity must be kept separate and distinct from the assets of the trustee of the entity, the members, or any related employer-sponsor of the fund.

2.22 According to the Treasury submission:

> Under general trust law, the trustee must take ultimate responsibility for the entity and is obligated to manage the assets of the entity with competence, diligence, prudence and honesty, and to act in good faith for the benefit of all of the members of the entity. These governance principles also underpin the SIS Act, most notably being reflected in the duties – or covenants – contained in section 52 of the SIS Act.[13]

2.23 According to the Chairman of the Corporate Superannuation Association, the overriding and strongest feature of a trust structure is that it reinforces the no conflict rule and the principle that trustees act for the benefit of the beneficiaries and not for their own profit.[14]

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12 ATO, *Submission 36*, p. 2.

13 Treasury, *Submission 55*, p. 6.

14 Mr Mark Cerche, Chairman, Corporate Superannuation Association, *Committee Hansard*, 5 March 2007, Melbourne, p. 37.

Trustee licensing

2.24 Since 1 July 2004, trustees have been operating under a universal framework of licensing and registration to ensure trustees satisfy certain minimum requirements before operating in the market. The licensing regime came into effect with the *Superannuation Safety Amendment Act 2004* that amended the SIS Act to require all trustees operating an APRA regulated superannuation entity to hold a Registrable Superannuation Entity (RSE) Licence. Existing trustees were granted a transition period of two years from 1 July 2004 to 30 June 2006. This licensing process has resulted in market rationalisation (see paragraph 2.27). By this time 307 trustees responsible for around 600 superannuation funds had obtained a RSE licence. A further 6300 small APRA funds (those with fewer than five members) were also licensed by the completion of the transition period. Trustees that have been granted an RSE licence manage combined assets of $566 billion out of a total of approximately $1 trillion in super funds.[15]

2.25 In order to obtain a licence trustees must, among other things, meet minimum standards of fitness and propriety and have adequate financial, human and technical resources, an adequate risk management framework and systems to manage the outsourcing of any material business activities.[16]

2.26 It is important to highlight that an RSE licence is not the same as an AFS licence, which is issued by ASIC to providers of financial products under the Corporations Act. While an RSE licence enables the licensee to conduct business operations different from those holding an AFS licence, holding an AFS licence is still a requirement for undertaking certain types of business activities under an RSE licence; for example, where the trustee is dealing in a financial product or providing advice about financial products.[17]

2.27 APRA is currently undertaking two supervisory tasks following the completion of the licensing transition period. The first is resolving issues created by the large number of funds and trustees that have recently exited the superannuation system. Over 140 trustees that had not completed the wind up of their funds by 30 June 2006 have entered into enforceable undertakings to do so within a specified period. The second task is monitoring the undertakings made by licensed trustees in regard to the policies and procedures put in place prior to licences being granted.[18]

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15 APRA, *Submission 51*, p. 4.

16 Treasury, *Submission 55*, p. 6.

17 Australian Prudential Regulation Authority, *Licensing and registering a superannuation entity: Explanatory guide on licensing and registration*, July 2004, pp. 6-7.

18 APRA, *Submission 51*, p. 4.

Sole purpose test

2.28 The trustee of a regulated superannuation fund must comply with the sole purpose test as set out in section 62 of the SIS Act. According to the relevant APRA circular, a regulated superannuation fund must be maintained solely for:

- at least one of the legislated 'core purposes', which are the provision of benefits on or after the member's retirement; and
- for one or more of the prescribed or approved 'ancillary purposes', which are the provision of employment termination insurance, salary continuance (on a member ceasing work because of ill health), reversionary benefits and other approved benefits on or after an appropriate condition has been met.[19]

2.29 The main objective of the sole purpose test is to ensure that superannuation assets are maintained solely for the purpose of or providing some form of retirement benefit to members. The test is meant to achieve this objective by prohibiting the use of tax concessions for purposes such as providing pre-retirement benefits to members, benefits to employer sponsors or facilitating estate planning.[20] The committee's main interest in the sole purpose was to examine whether expenditure on promotional advertising by superannuation funds, especially since the advent of Choice of Fund on 1 July 2006, is consistent with the sole purpose test. The views of APRA and other industry stakeholders on this issue are examined by the committee in Chapter 3.

Committee view

2.30 A thread running through evidence from peak industry associations and other stakeholders is that the laws and regulations governing superannuation have become too complex, onerous and conflicting in some instances and have not kept pace with industry developments. Even the Productivity Commission's detailed review of the SIS Act and regulations noted the complexity and length of the legislation and that it has been subject to persistent and frequent change, thus making it difficult to be familiar with: 'As a result, there is reason to consider how it might be improved, including whether comprehensive changes might be justifiable'.[21]

2.31 The committee agrees with this assessment, although it did not receive much evidence in relation to the operation of the SIS Act and regulations. Some in the industry expressed the view that the legislation is repetitive, clumsy, ambiguous and contains unnecessary definitions that, in the words of Trowbridge Deloitte consultant

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19 Australian Prudential Regulation Authority, Superannuation Circular no. III.A.4, The *Sole Purpose Test*, February 2001

20 Productivity Commission, *Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, pp. 117-18.

21 Productivity Commission, *Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, p. xx.

Mr Anthony Asher: '…makes life very difficult for anyone working in the industry'.[22] Trowbridge submitted further that the SIS Act and regulations contain counter-intuitive definitions and compare unfavourably with other acts administered by APRA as well as some international legislation such as the Canadian Pension Benefits Standards Act (1985). The submission made a number of practical suggestions to simplify the legislation, including:

- transferring those parts and sections administered by the ATO and ASIC to legislation they administer;
- rationalising APRA's powers under the licensing regime to enable it to issue prudential standards that specifically cover operating risks and fiduciary standards;
- removing the distinction between superannuation funds and approved deposit funds, pooled superannuation trusts and retirement savings accounts; and
- removing 'member protection' that prevents administration charges exceeding investment earnings for accounts of less that $1000.[23]

2.32 Strongly worded criticism of the superannuation legislation came from Mercer Human Resource Consulting. It argued that the worst examples of complexity and ambiguity are found in recent legislation such as the Corporations Law, which is '…just unintelligible'. Moreover:

> Once you have waded through [the Corporations Law], you then have to check whether there is an ASIC policy statement or class order that may override the regulations. In some cases we have legislation that is written so ambiguously that the various regulators cannot even agree on what the legislation means. In other cases it is the inconsistencies in the legislation that are a problem.[24]

2.33 The committee believes that the level of concern expressed by industry stakeholders about the complexity of the SIS Act would justify the government undertaking a comprehensive review of superannuation laws. This should be carried out by Treasury.

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22 Mr Anthony Asher, Consultant, Trowbridge Deloitte, *Committee Hansard*, 7 March 2007, Sydney, p. 43.

23 Trowbridge Deloitte, *Submission 80*, p. 17.

24 Mr John Ward, Principal Manager, Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, p. 65.

Recommendation 2

2.34 The committee recommends that Treasury conduct a review of the laws and regulations governing superannuation to identify how they may be rationalised and simplified.

2.35 Other concerns with the SIS Act and Corporations Act and those acts that cover the regulators generally fall within one of four main areas:

- regulatory overlap between APRA and ASIC, especially in the areas of data collection, reporting and notification of change;
- confusion over the status of APRA's guidance with regard to how it interprets and assesses compliance with the operating standards set out in the SIS regulations;
- additional complexity for trustees and the financial planning industry, especially meeting the product disclosure requirements of FSR legislation; and
- rapidly increasing compliance costs that are passed on to the consumer that have made it difficult for many fund members to receive cost-effective financial advice.

2.36 In relation to the 'twin peaks' model of regulation, the committee notes that while the responsibilities of the three regulators (ASIC, APRA and the ATO) are specified in law, in practice there is some administrative overlap and duplication of functions. This emerged as a consistent theme in evidence to this inquiry. The issue of duplication of information gathering between APRA and ASIC was highlighted by CPA Australia, specifically in relation to the recent transition period for trustee licensing:

> …we had Australian finance services licensing two or three years ago and we have just gone through the two-year transition period for trustee licensing under APRA. There were a lot of the same questions and a lot of the same requirements, although perhaps couched a bit differently. The trustees had to jump through the same hoops again, providing the information to APRA, when a lot of it could have been shared in the first place. Because we have that separation, we end up with a lot of duplication.[25]

2.37 The committee notes that while steps have been taken by the regulators to address this issue, for example by entering into memoranda of understanding to define responsibilities more clearly, some sections of the superannuation industry support a review of the 'twin peaks' system to overcome what is perceived to be conflict involving different regulatory perspective and objectives. The issue of regulatory overlap are matters of real concern for the committee and are examined in Chapter 3.

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25 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 59.

It is noteworthy that the industry as a whole, including some of those levelling criticism at the legislation, believe the regulatory framework for superannuation created by the SIS Act, for all its faults, continues to provide an efficient and effective legislative framework for the prudent management of superannuation funds.

Industry trends: A snapshot

Growth in superannuation savings and industry composition

2.38 In early 2007 total superannuation assets reached the $1 trillion mark, backed by strong equity markets and a guaranteed flow of money that some researchers estimate could double in size by 2015.[26] This was up from $761.9 billion in June 2005 and four times the value of superannuation assets in June 1995 ($250 billion).[27]

2.39 During the March 2007 quarter superannuation assets grew by $44.7 billion or 4.4 per cent, to $1.1 trillion, which represents a 17.1 per cent increase over the 12 months to March 2007.[28] According to APRA's media release:

> Industry funds showed the strongest growth during the quarter, with assets increasing by 6.2 per cent ($10.6 billion) to $182.7 billion. Public sector fund assets grew by 5.1 per cent ($8.0 billion) to $165.8 billion, retail fund assets by 3.7 per cent ($12.4 billion) to $343.9 billion and corporate fund assets by 2.6 per cent ($1.7 billion) to $69.4 billion.[29]

2.40 The shifts that have occurred within the superannuation industry over the past decade have seen the emergence of four distinct streams of superannuation funds (of which the first three are APRA-supervised funds):

- corporate funds that are sponsored by a single employer or group of related employers and cover their employees;
- industry funds that cater for members as a result of an agreement between parties to an industrial award. Some industry funds offer their products to the public at large, like retail funds;
- retail funds that are public offer superannuation funds that members join by purchasing investment units or policies that are sold through intermediaries such as financial planners; and

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26 'APRA figures show superannuation assets reach $1.0 trillion', APRA Media Release, 29 March 2007; Jonathan Barrett and Brendan Smith, ' Super industry swamped by cash flow', *Australian Financial Review*, 21 January 2007, pp. 40-41.

27 Treasury, *Submission 55*, p. 4.

28 APRA, *Quarterly Superannuation Performance March 2007*, issued 28 June 2007.

29 'APRA figures show superannuation assets reach $1.1 trillion', Media release No. 07.22, 28 June 2007.

- Self-managed superannuation funds (SMSFs).[30]

2.41 At March 31 2007, retail funds held the largest proportion of superannuation assets, accounting for 32.6 per cent of total assets, followed by self-managed superannuation funds with 23.3 per cent, industry funds 17.3 per cent, public sector funds 15.7 per cent and corporate funds 6.6 per cent. Small APRA funds held 0.3 per cent of total assets.[31]

2.42 The committee notes that while the level of superannuation assets in Australia has overtaken $1 trillion, there remains a high level of industry concern that many people's expectations of their living standards in retirement greatly exceeds what their superannuation savings will actually provide. This is commonly referred to as the retirement savings gap. There is also concern with the poor level of overall financial literacy in the community and the high level of disengagement over retirement savings and superannuation issues, especially among younger people.

Choice of Fund

2.43 The significant growth in the level of superannuation savings over the past decade should be viewed in the context of government attempts to introduce choice and portability of superannuation and widen the eligibility criteria for low income earners to receive the government co-contribution.[32] Government policy to give employees the right to choose which superannuation fund receives the superannuation guarantee contributions was first articulated as part of the 1997-98 budget process. Attempts by the government to pass choice of superannuation legislation in 1997 and 1998 were unsuccessful. However, the policy was implemented by the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004*. The Choice of Fund regime commenced operation on 1 July 2005 for federal awards and 1 July 2006 for state awards.

2.44 Where an employee does not choose a superannuation fund, the employer may choose a complying fund provided it is an 'eligible choice fund'.[33] Various groups of employees are excluded from the coverage of the choice of fund legislation, including Commonwealth public sector employees, employees covered by state awards and employees covered by a certified agreement or an Australian Workplace

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30 Productivity Commission, *Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, pp. 20-21.

31 APRA, *Quarterly Superannuation Performance March 2007*, issued 28 June 2007, p. 5.

32 *Australia's corporate regulators—the ACCC, ASIC and APRA*, Research brief no. 16 2004-05, Department of the Parliamentary Library, 14 June 2005, p. 9.

33 An eligible choice fund is a complying superannuation fund, a retirement savings account, a fund presumed to be a complying superannuation scheme under section 24 of the *Superannuation Guarantee (Administration) Act 1992*, or a fund presumed to be a complying superannuation fund under section 25 of the act.

Agreement that stipulates the superannuation fund to which contributions are to be made on behalf of the employees.[34]

2.45 Choice of Fund has been a central part of the government's agenda since 1996. The main arguments in support of choice of fund arrangements are that it gives employees greater control over their superannuation savings, a greater sense of ownership of these savings and increases the competitiveness of the market for superannuation products.[35] The committee acknowledges and supports the principle of people having the freedom of choice of both superannuation fund and investment options, provided appropriate prudential regulation and licensing is in place to ensure people are protected from unwarranted risk. The committee believes that in the long run (and with appropriate safeguards in place) choice will increase competition, resulting in efficiencies and improved returns on superannuation savings. It is still early in the new regime's operation and, as yet, there is no evidence that operational costs have been reduced.

Demise of defined benefit funds

2.46 Superannuation funds normally fall in to one of two categories: defined benefit (DB) funds and defined contribution (DC) funds, which are widely known in Australia as accumulation funds. Defined benefit schemes calculate the final benefit based on a predetermined formula unrelated to the fund's performance, which may take into account a members' final salary, length of service and salary averaged over a period or at a particular point in time, rather than the investment earnings of the fund. Thus if market returns decline to leave the fund in deficit, the fund's sponsor is required to contribute money to ensure members receive their promised entitlements. Under the SIS Act, DB funds are required to undergo periodic actuarial reviews to maintain its assets at an adequate level to meet the obligation to pay current and future benefits.[36] In Australia, DB funds have generally been managed by individual companies and employers through their corporate pension fund, or as public sector schemes.

2.47 Defined benefit funds stand in stark contrast to accumulation funds where the end benefit is made up of contributions to the funds plus any investment earnings less costs. Under this arrangement, the financial risk of retirement saving is borne by the fund member. Employers simply pay an agreed amount into their employee's fund.

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34 *Superannuation ready reckoner: taxation and preservation rules for 2004-05—revised February 2005*, Research Brief no. 10, 2004-05, 14 February 2005, pp. 9-10.

35 *Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*, Bills Digest No. 31 2002-03, Department of the Parliamentary Library, pp. 13-14.

36 APRA, 'Adoption of International Financial Reporting Standards', *Discussion Paper*, 24 February 2005, p. 17. See also Guest, R. et al, 'Employees' Choice of Superannuation Plan: Effects of Risk Transfer Costs', *Journal of Industrial Relations*, Vol 46, No. 1, March 2004, p. 2.

This regular payment fully discharges the employer's obligations, while fund members receive a final amount determined by their contributions plus investment earnings.[37]

2.48 The Treasury submission made the following important distinction between the structure and funding arrangements of DB and accumulation funds (which are reflected in the SIS Act):

> As a defined benefit entitlement is not linked, or only partially linked, to market reforms, it is the employer-sponsor who bears the financial risk of ensuring the fund is able to meet its benefit promises to members. In contrast, an accumulation fund pays benefits to members equal to the amount accumulated in the fund in respect of the member, being made up of contributions and investment earnings, less fund expenses. Consequently, members directly bear the investment risks in accumulation funds, including the risk of investment losses.[38]

2.49 Of the two, accumulation funds are overwhelmingly the most common variety in operation in Australia in 2007. However, this was not the case three decades ago. Prior to the major reforms of the superannuation system beginning in the mid-1980's, superannuation schemes covered only 45 per cent of employees and were primarily of the defined benefit variety.[39] In 1982-83, 82 per cent of superannuation fund members were in defined benefit funds. By 1999-00 the figure had dropped to 14 per cent.[40]

2.50 The gradual decline in the number of defined benefit funds is shown in Table 1. The committee notes that the closure of many defined benefit schemes and their replacement with accumulation-style funds is a global trend.[41] According to a Parliamentary Library research paper:

> Demographic trends and reforms to pension systems towards the privatisation of pension savings, will most likely reinforce the creation of more and larger pools of investment capital that will be managed via [accumulation] schemes.[42]

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37 Guest, R. et al, 'Employees' Choice of Superannuation Plan: Effects of Risk Transfer Costs', *Journal of Industrial Relations*, Vol 46, No. 1, March 2004, p. 2.

38 Treasury, *Submission55*, p. 17.

39 Allan Borowski, 'The revolution that faltered: two decades of reform of Australia's retirement income system', *International Social Security Review*, vol.58, no.4, 2005, p. 46.

40 Productivity Commission, *Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, p. 19.

41 Recruitment and Consulting Services Association and the Professional Associations Superannuation Limited, *Submission 56*, p. 11.

42 Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, Department of the Parliamentary Library, Economics Section, May 2007, p. 23.

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

2.51 The committee notes that the decline is likely to be a long term trend. Evidence before the committee pointed to a number of possible reasons for the trend. The complexity associated with DB funds has been accompanied by the problem of unfunded liabilities accrued during periods where market returns fall short of benefits owed to members. While this was not a pressing issue for defined benefit funds during the 1990's, many were abruptly reminded of the financial risk they were bearing when market returns declined after the technology bust and global instability that characterised the early part of the decade. An analysis of many corporate funds' unfunded liabilities in 2003 found that:

> In the 1990's, defined benefit funds largely took care of themselves, with strong returns allowing many companies to have contribution holidays during the bull market. But this has changed over the past four years, with sharp falls in nearly all major stockmarket indexes.[43]

2.52 There was considerable concern at the time that many companies would have to contribute a proportion of their profits to rectify fund deficits. In March 2003 APRA released the results of its survey on the health of DB funds. It concluded that while larger funds remained generally solvent, the capacity of a majority of smaller funds to meet their present and future obligations had declined by more than ten per cent. APRA encouraged employer sponsors to, where applicable, 'contribute to their funds at the actuarially recommended rate'.[44] Although subsequent buoyant market conditions alleviated those immediate solvency concerns, the prospect of uncertainty over business profits when markets are trending down is a strong disincentive for companies to manage defined benefit funds.

2.53 Other reasons were also identified. The cost of obtaining a licence in terms of time, resources and funding, together with the progressive adoption of new international financial reporting standards for APRA-regulated reporting entities from 1 July 2005, have been driving the recent decline in the number of DB funds. While these are comparatively new factors, other likely reasons for the decline in DB funds in Australia have been identified:

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43 John Stensholt and James Thomson, "The super 'time-bomb'", *Business Review Weekly*, vol.25, no.14, 17-23 April 2003, p. 15.

44 APRA, 'APRA releases results of defined benefit superannuation funds survey', *Media Release*, 27 March 2003.

- 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;
- the move away from corporate defined benefit schemes is part of modern corporate management practice. Corporate sponsors recognise that the provision of superannuation benefits is not part of their 'core' business – it is less trouble to outsource this part of their activities;
- 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' industrial relations, and
- accumulation funds are relatively simple to operate and the size of their benefits is very easy for members to understand.[45]

2.54 As previously noted, through its Super Choice regime the government has encouraged a competitive and efficient market in superannuation fund products by allowing consumers almost unlimited choice in the marketplace. In theory, the investment risks borne by accumulation fund members should be compensated by the ability to choose funds that offer the most suitable arrangements and/or best returns. Consequently, superannuation funds that perform below a reasonable standard will be uncompetitive when held against better performers.

Benchmarking international practice

2.55 The committee's term of reference number 13 refers to benchmarking Australia against international practice and experience. During the early stages of the inquiry, the committee sought assistance from the Parliamentary Library and requested that it prepare a research paper on this issue, with particular attention to be given to two of the most relevant overseas jurisdictions: the United Kingdom (UK) and the United States (US). The paper provided background on a number of issues in the terms of reference by comparing relevant features of the retirement income systems of Australia, the UK and the US.[46]

2.56 While the paper found that Australia's superannuation industry overall compares favourably with that of the UK and the US, it emphasised there are no agreed international benchmarks on the structure of superannuation systems and their

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45 Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, Department of the Parliamentary Library, Economics Section, May 2007, p. 24.

46 A final version of the paper was presented to the committee in May 2007 and subsequently made available as a public document on the committee's inquiry website: Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, Department of the Parliamentary Library, Economics Section, May 2007.

regulation and supervision. The committee notes that APRA has been working closely with OECD working groups on the international stage in the development of guidelines on regulation, supervision, investment practices and other related subjects from which international benchmarks may eventually emerge.[47]

2.57 The APRA submission described the regulator's contribution, as a foundation member of the International Organisation of Pension Supervisors (IOPS), to the development of the IOPS Principles of Private Pension Supervision.[48] These principles were approved by the organisation's governing membership at its annual general meeting held in December 2006. According to the final document:

> The main objective of private pension supervision is to promote the stability, security and good governance of pension funds and plans, and to protect the interests of pension fund members and beneficiaries. Pension supervision involves the oversight of pension institutions and the enforcement…and promotion of adherence to compliance with regulation relating to the structure and operation of pension funds and plans, with the goal of promoting a well functioning pensions sector. In addition, achieving stability within the pension sector is an important part of securing the stability of the financial system as a whole.[49]

2.58 There are currently ten IOPS principles of private pension supervision. These include:

- objectives: national laws should assign clear and explicit objectives to pension supervisory authorities;
- independence: pension supervisory authorities should have operational independence;
- adequate resources: pension supervisory authorities require adequate financial, human and other resources;
- adequate powers: pension supervisory authorities should be endowed with the necessary investigatory and enforcement powers to fulfil their functions and achieve their objectives;
- risk orientation: pension supervision should seek to mitigate the greatest potential risks to the pensions system;
- proportionality and consistency: pension supervisory authorities should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated and that their actions are consistent;

47 APRA, *Submission 51*, p. 12.

48 The IOPS describes itself as an independent international body representing those involved in the supervision of private pension arrangements.

49 The International Organisation of Pension Supervisors, *IOPS Principles of Private Pension Supervision*, 7 December 2006, Istanbul, Turkey, p. 2.

- consultation and cooperation: pension supervisory authorities should consult with the bodies they are overseeing and co-operate with other supervisory bodies;
- confidentiality: pension supervisory authorities should treat confidential information appropriately;
- transparency: pension supervisory authorities should conduct their operations in a transparent manner; and
- governance: the supervisory authority should adhere to its own governance code and should be accountable.[50]

2.59 APRA submitted that these principles could facilitate benchmarking across different superannuation systems, at least within countries that are members of IOPS.[51] To facilitate this process, APRA is currently involved in a joint IOPS and OECD working party project on private pensions relating to the development of licensing guidelines.

Committee view

2.60 The committee notes that no attempt has been made by the government to benchmark Australia against international practice and experience. It is difficult to compare Australia's compulsory, privately managed and prudentially regulated system with the wide variety of systems operating in other countries. The Parliamentary Library research paper found that when comparing the Australian industry and regulation with 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'.[52] One particular area of difficulty relates to retirement savings products and the methods of charging for those products. The Association of Superannuation Funds of Australia (ASFA) submission noted that in some countries the remuneration of financial planners is bundled into the fees attached to retirement savings products, while in others the two are quite separate.[53]

2.61 There are currently no internationally agreed standards upon which to draw any firm conclusions. According to the Treasury submission, the difficulty arises in part because of '…the diversity of policy objectives, regulatory structures and historical development and the absence of internationally agreed standards upon which to base any international comparison'.[54] This is arguably the main reason why

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50 The International Organisation of Pension Supervisors, *IOPS Principles of Private Pension Supervision*, 7 December 2006, Istanbul, Turkey.

51 The IOPS currently has around 60 members and observers representing approximately 50 countries and territories worldwide.

52 Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, Department of the Parliamentary Library, Economics Section, May 2007, p. 3.

53 ASFA, *Submission 68*, p. 42.

54 Treasury, *Submission 55*, p. 24.

the committee received almost no evidence that addressed term of reference 13. The committee assumes that Treasury monitors international trends, especially through OECD processes. However, the government rightly relies on ASIC and APRA as the main regulators to focus on international trends and activities, which they do.

2.62 The committee notes APRA's view that there is nothing in the prudential regulation of superannuation in Australia that is contrary to trends in best practice that are beginning to emerge internationally, as reflected for example in the recently agreed IOPS principles. Treasury noted that Australia's 'three pillar' retirement income system is consistent with the multi-pillar design approach that the World Bank has endorsed as a more efficient and effective approach to deliver retirement incomes.[55] However, the committee believes that comparing Australia's superannuation system favourably with other systems is no excuse for the government or industry to discount international trends in superannuation policy. While few would contest the widely held view that Australia has a world class retirement income system that is the envy of many other countries, this does not mean that other systems have nothing to offer or that the government and the industry cannot learn from overseas developments.

2.63 ASFA highlighted one area where Australia does not score very highly on the international rankings, that being retirement income adequacy:

> Australia's retirement income system delivers relatively good protection against poverty, but current and even prospective replacement rates of income and expenditure in retirements are not high by international standards. There would appear to be both scope and need to boost effective net contribution rates to superannuation so as to improve outcomes.[56]

2.64 The Parliamentary Library research paper also identified areas of Australia's retirement savings system that do not compare favourably with the equivalent UK and US systems. These include:

- the provision of retirement advice by advisers closely associated with the superannuation fund provider;
- superannuation fund trustees' responsibility to prudently manage fund 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;

55 Treasury, *Submission 55*, p. 24.

56 ASFA, *Submission 68*, pp. 41-42.

- whether the trustees of a superannuation fund should have the obligation to report missing contributions from an employer, instead of the ATO 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 AFS licence are required to do.[57]

2.65 The committee is surprised that there has apparently not been any empirical research undertaken by either the industry or APRA on the superannuation systems of other countries. While the industry as a whole views Australia as setting international benchmarks in superannuation and retirement incomes policy, no attempt appears to have been made at an academic, regulatory or industry level to assess the retirement income systems of other countries in detail, and identify any features that might be relevant to Australia's superannuation system.

Recommendation 3

2.66 The committee recommends that APRA, in consultation with peak superannuation bodies and academics in particular, undertake empirical research on the strengths and weaknesses of superannuation systems operating in other OECD countries, and that the findings be made publicly available. The aim is to develop a framework for benchmarking Australia's superannuation system against international best practice.

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57 Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, , Department of the Parliamentary Library, Economics Section, May 2007, pp. 3-4.

Chapter 3

Transparency in reporting requirements

3.1 This chapter examines issues raised during the inquiry that relate to the regulatory arrangements pertaining to the reporting requirements of superannuation funds. The first explores the debate over whether promotional advertising complies with the sole purpose test, including discussion on how such expenditure should be disclosed to fund members. The second is the use of the term 'not for profit' by industry funds in the context of third party transactions with service providers, and the propriety and transparency of these relationships. Finally, the chapter examines complaints from the superannuation industry about the inefficiencies and cost associated with regulatory overlap.

Promotional advertising

3.2 Promotional advertising is an established practice for industry and retail superannuation funds in Australia. It has become increasingly important to their survival in a competitive marketplace. It is estimated that in the twelve months to November 2006, industry funds spent $18.8 million on advertising, accounting for 83.5 per cent of the $26.1 million spent on superannuation advertising in that year, up from 72 per cent in 2005.[1]

3.3 During the inquiry, the committee examined the operation of the sole purpose test in the context of advertising undertaken by trustees on behalf of fund members. The hearings saw extensive discussion on the appropriateness of this practice, particularly in the light of the 'compare the pair' and 'A lifetime of difference' super choice advertising campaign by Industry Funds Services (IFS) that sought to highlight the advantages to investors of industry funds over comparable retail funds. In May 2005 IFS suspended its advertising campaign following concerns that consumers might have been confused by the advertisements. In June of that year, the Australian Securities and Investments Commission (ASIC) accepted an enforceable undertaking from IFS in relation to the advertising campaign.

3.4 According to ASIC Deputy Chairman, Mr Jeremy Cooper, the advertising campaign by IFS reinforced ASIC's view that all advertising about choice of superannuation fund must be clear, accurate and unambiguous, with the correct level of detail set out for consumers:

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1 Brendan Swift, 'Choice of fund inspires super spending', *Australian Financial Review*, 10 January 2007, p. 42, based on research by Nielsen Media Research AdEx. Industry funds point out that they represent only 7 per cent of advertising within the financial services sector, compared with a 38 per cent share held by financial planners and a 22 per cent share by market and retail super funds. See, for example, Industry Super Network, *Submission 77*, p. 13.

> ASIC will continue to work cooperatively with the superannuation industry to ensure that any concerns are resolved quickly and in the interests of better information to consumers. We certainly don't want to stop funds from explaining the benefits of their products to consumers, provided they don't go too far.[2]

Sole Purpose Test

3.5 The sole purpose test and associated standards contained in section 62 of the SIS Act prohibit the use of concessionally taxed superannuation savings for purposes such as providing pre-retirement benefits to members, benefits to employer sponsors or facilitating estate planning. The test ensures that the retirement income objective remains paramount. Specifically, the test requires that each superannuation fund be maintained solely for core purposes as set out in the legislation.[3]

3.6 The three legislated core purposes are:

- provision of benefits for each fund member on or after the member's retirement from any business, trade, profession, calling, vocation, occupation or employment in which the member was engaged;
- provision of benefits for each fund member on or after the member attaining the age of 65; and
- provision of benefits to a legal personal representative or dependants of a fund member on or after their death, provided that the death occurs prior to age 65.

3.7 The test also requires that funds be maintained for one or more ancillary purposes, which include:

- provision of benefits for each member on or after termination of employment with an employer who had contributed for the member;
- provision of benefits where the member temporarily or permanently falls ill and ceases work;
- provision of benefits to a member's legal representative or dependants where the member dies after reaching age 65; and
- provision of other benefits approved by the Australian Prudential Regulation Authority (APRA). Circumstances commonly covered by this purpose include hardship or long service leave.[4]

3.8 The test encompasses the normal activities of fund trustees, including the levying of reasonable charges against contributions of fund assets to pay for services

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2 ASIC, 'Industry Fund Services agrees to change advertising', Press Release 05-148, 3 June 2005.

3 Comprehensive coverage of the Sole Purpose test can be found in *Superannuation Circular no.III.A4*, Australian Prudential Regulation Authority, February 2001.

4 SIS Act section 62(1)(b), regulations 6.01, and schedule one items 103, 108, and 109.

being provided to members, provided those services are reasonably incidental to the running of the fund. The test allows legitimate administrative expenses, including fund sponsored member awareness, education and financial advice programs so long as they are directed at specific superannuation-related issues. APRA's advice states that, as a general guiding principle, there should always be a reasonable, direct and transparent connection between particular trustee action and the sole or ancillary purposes.[5]

3.9 In its submission, APRA reproduced a letter sent to all funds under its regulation offering guidance in relation to promotional advertising. The letter addresses factors going to the appropriateness of directing members' funds to various advertising and promotional activities, and delineates between member education, marketing to retain or expand membership, joint campaigns, external financing, and selection of service providers. Consistent with its previously published Circular, APRA wrote that member education in relation to features of the fund was usually permissible, but that broad financial literacy campaigns should not be undertaken using members' assets.

3.10 In relation to retaining existing members or seeking to recruit new ones, the letter said, in part:

> In our view, imposing marketing expenses on current members primarily to attract new members is difficult to justify [and] imposing marketing expenses on current members where the benefit of such expenses falls primarily to the trustee (by way of enhanced remuneration) or other parties would be inconsistent with the sole purpose test and may give rise to inequities among generations of members.[6]

Industry views

3.11 The majority of witnesses appearing before the committee viewed advertising as a fact of the modern, market-oriented superannuation industry and defensible as an appropriate activity connected to the core purposes prescribed in the SIS Act and regulations. Besides arguing that advertising is a basic necessity, a number of witnesses argued that greater market share brought with it efficiencies that were directly beneficial to investors. Some of the areas in which economies were said to be achieved were office accommodation, governance, auditing, accounting, legal, quality review and systems technology costs.[7]

3.12 Superpartners took a popular line, arguing that the greater membership flowing into industry funds as a result of advertising brought about efficiencies of

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5 *Superannuation Circular no.III.A.4*, Australian Prudential Regulation Authority, February 2001, para. 42.

6 Letter to trustees of all APRA-regulated superannuation funds, Mr Ross Jones, 14 March 2005, reproduced from APRA, *Submission 51*, p. 11.

7 Industry Super Network, *Submission 77*, p. 14.

scale that served the investor well. The greater the membership the more costs could be spread and driven down.[8] This view was echoed by REST Superannuation:

> In regard to the payment of advertising from the fund, we genuinely believe that this can be justified as a legitimate expense in the correct circumstances. Section 62 of SIS, that is, the sole purpose test, sets out that each trustee of a regulated super fund must ensure that the fund is maintained solely for the provision of retirement benefits for each member of the fund. Whether spending the fund's money on promotional advertising is in conflict with this test, that is a test that needs to be addressed by each trustee. We hold the view that existing members of a fund benefit from promotional advertising as it helps to assist existing members to stay with the fund and educate them about the benefits of the fund or enables new members to join the fund, potentially giving greater economies of scale.[9]

3.13 Industry Super Network (ISN) argued that industry funds saw advertising as entirely consistent with the sole purpose test:

> We have said all along that we are certainly not looking for any exemption from the sole purpose test. We think it ought to be judged in terms of the sole purpose test. We think the economies of scale in the superannuation industry generally are so overwhelming that almost the reverse case can be made; that unless trustees are doing really active things about trying to grow their membership base—and their funds under management, in particular—then maybe they are not really carrying out the sole purpose test, which is to maximise the benefits for the fund members. That is simply because, other things being equal, the unit cost per member can be expected to be lower as a fund grows or if a fund is bigger than other funds.[10]

3.14 Through its involvement in the 'compare the pair' advertising campaign and its sponsorship of a football team, HostPlus argued that it took a targeted approach to promotional advertising:

> These promotional activities are undertaken to sustain and enhance our membership base through building the brand and brand awareness. That largely enables us to build on the economies of scale which in turn provide us access to competitive management and administration fees, which, as I think you will all agree, is ultimately in our member's interests. Our strategy is tailored to reach our membership, who are predominantly in the

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8 Mr Frank Gullone, Chief Executive Officer, Superpartners, *Committee Hansard*, 25 October, Melbourne, 2006, p. 15.

9 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, 24 October, Sydney, 2006, p. 57. See also, for example, Mr Michael Potter, Director, Economics and Taxation, Australian Chamber of Commerce and Industry, *Committee Hansard*, 6 March 2007, Melbourne, p. 43; ESI Super, *Submission* 85, p. 014; Members Equity Bank, *Submission* 64, p. 4.

10 Mr Garry Weaven, Spokesperson, ISN, *Committee Hansard*, 6 March 2007, Melbourne, p. 28. See also, for example, Equipsuper, *Submission* 30, p. 14.

> 21- to 40-year age category. They are typically disengaged with their superannuation, and it is difficult to reach them solely through some of the traditional channels, such as the annual members statement and annual reports. So building our brand through TV advertising and through our association within the sporting industry is critical to our activity in the same way as administration and investment management. Advertising is a legitimate cost, just like any other costs that the fund incurs, whether they be administration or investment costs. It should not be considered any differently. As we have heard previously from others who have discussed this issue, its primary objective is to retain our existing members, build on the existing membership base and grow our funds under management, which all lead to greater economies.[11]

3.15 HostPlus used practical examples to demonstrate how efficiencies are achieved through growth in membership:

> Certainly a good case in point as it relates to HostPlus is that we were able to increase the level of insurance benefits that our members received by a minimum of seven per cent last year at no additional cost to the members. We were able to negotiate with our insurer increased benefits, and it did not cost our members any additional moneys whatsoever. I think this really highlights the true nature of what you can do if you have economies built into your membership base.[12]

3.16 The submission from ISN was also illustrative of the economies of scale achievable through maximising the quantum of funds under management:

> The relationship between scale of funds under management and investment charges is also probably fairly well known. As an indication, for a standard active Australian shares mandate, costs can range from below 0.3 per cent of assets under management to almost 2 per cent, with the largest factor being the size of the mandate.[13]

3.17 Fund research organisation SuperRatings argued strongly for the right to advertise, to the extent of claiming that a board of directors which fails to address the need for promotion is potentially compromising the success of their business and the financial wellbeing of their clients.[14] The Self-Managed Super Fund Professionals' Association of Australia (SPAA) also saw advertising as an integral part of running a superannuation fund:

> Advertising is interesting, because whether it is done internally by the superannuation fund or externally by a service provider to those particular

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11 Mr David Elia, Chief Executive Officer, HostPlus, *Committee Hansard*, 6 March 2007, Melbourne, p. 55.

12 Mr David Elia, Chief Executive Officer, HostPlus, *Committee Hansard*, 6 March 2007, Melbourne, p. 55.

13 ISN, *Submission 77*, p. 14.

14 SuperRatings, *Submission* 49, p. 9.

> funds, it would seem that promotion is part and parcel of superannuation. To get people educated and to have them understand particular products within the industry is probably worthwhile.[15]

3.18 This approach was also taken by Mercer Human Resource Consulting, which viewed the issue in the following terms:

> In our view, funds have to obtain new members to remain viable. How do you obtain new members? You can do it in a number of ways. You can advertise, you can pay salesmen commissions to attract new members, or you can pay employees to go out on a salary basis and recruit new members. If you are going to ban one, should you ban all three? We find it very difficult to see how you can effectively stop one segment of the industry from attracting members in a particular way …we need to recognise that the super industry has been through a significant structural change, and yet that is still happening. The number of funds in the industry is still diminishing. We are suggesting that within five to 10 years, the top 10 funds will represent perhaps 40 per cent of the industry, if you exclude the public sector and the self-managed super funds. They will be major financial services players, whether they are an industry fund, a bank or some other player. All of those players will have a brand. That brand is important, and it will be advertised in a variety of ways, whether it be through a sales force, direct advertising, or on the internet, et cetera. Member information is important. We live in a competitive environment. Those funds will compete with one another in all sorts of ways. I think that is a fact of life that is part of fund choice. We need to recognise that.[16]

3.19 Rainmaker Information spoke strongly about the nexus between a market-based, free choice super regime and the ability to advertise. It called for the focus to be shifted to a lowering of overall operating costs:

> The whole point of super choice is to open the market to competition and to let consumers choose who should look after their money. Therefore, it is a force for good, in our view, because it simply democratises the industry. It puts the focus on members and not just employer sponsors or their union sponsors. In this environment advertising can be necessary because it is simply a very cost-effective way to communicate with large numbers of members and large numbers of prospective members. We believe imposing advertising restrictions just because it is superannuation is anti choice, anti consumer, anticompetitive and even, dare I say, unAustralian. Our plea is simply that people concerned about advertising costs should really be fighting to minimise total operating costs and passing these savings on to members as the lowest possible fees. Again, we are concerned that we could be trying to solve the wrong problem. Even worse, advertising controls could be tantamount to trying to tell trustees how to actually run

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15 Mr Graeme Colley, Director, SPAA, *Committee Hansard*, 24 October 2006, Sydney, p. 6.

16 Mr John Ward and Mr David Knox, Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, p. 73. See also, for example, Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, pp. 4-5.

> their operating budgets, which we think—while it might be ideal in some cases—could actually end up being quite naive and unworkable. [17]

3.20 A small number of respondents argued against allowing industry funds to advertise using members' money. Typical of these was Fiducian Portfolio Services, who considered that advertising during prime time on television was needlessly expensive, and was of dubious utility.

> Industry funds are known to be charging their funds for advertising. Much of this is done during prime time viewing and is costing their members millions of dollars that could well be credited to member accounts. As well, we are of the opinion that the salaries and expenses of not for profit funds and industry funds are being paid be members. We cannot understand what benefit industry groups and unions can gain by participating in the financial services industry.
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> …
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> It would be interesting to know how many millions of dollars have been spent by industry funds on advertising and how this money would have benefited their members instead of the television campaigns[18]

3.21 The Financial Planning Association of Australia (FPA) questioned whether general advertising met the sole purpose test:

> In the view of the FPA, any general advertising by a fund does not arguably meet the "sole purpose" test under SIS as it is not directly related to any of the core purposes of a fund. Additionally, the general trust law does not on the face of it seemingly authorise a trustee to reimburse itself for the cost of general advertising as it would not seem to fall within normal administration activities of the trustee.[19]

3.22 The FPA also raised concerns relating to ancillary benefits, such as entertainment, which may fall to trustees or managers as a result of advertising activities. At the very least, it argued that such spending and ancillary benefits should be disclosed to members.[20]

Conveying information

3.23 A number of witnesses saw inherent value in the role of advertising in the provision of information to members or potential members. The Association of Superannuation Funds of Australia (ASFA) saw advertising not simply as a means of attracting business, but as a method of continuing financial education:

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17 Mr Alex Dunnin, Editorial and Research, Rainmaker Information, *Committee Hansard*, 24 October 2006, Sydney, p. 74. See also Mr David Elia, Chief Executive Officer, HostPlus, *Committee Hansard*, 6 March 2007, Melbourne, pp. 55-56.

18 Fiducian Portfolio Services, *Submission* 18, pp. 4-5.

19 FPA, *Submission* 38, p. 13.

20 FPA, *Submission* 38, p. 13.

> Partly it is knowing what their fund does. It is almost education. If I look at some of the promotion that is going around, my view is that it is as much aimed at those who are currently members of the fund, so that they understand what they are members of and why, as to get new members. One of the things that we do know is that a lot of people unfortunately do not know much about their fund. In a sense the visibility of the fund acts as much as an education event as it does to get other new members in.[21]

3.24 Superpartners saw a link between choice and deregulation in the industry with the recent increase in advertising, pointing out that advertising was directed:

> … [N]ot only [at] promotion of those funds but education of members in terms of understanding what the industry funds stand for. It has come about, really, as a result of choice and it has proved to be beneficial, based on anecdotal evidence. Members have a better understanding of what industry funds are about.[22]

3.25 Superpartners reminded the committee that provision of information and efforts by funds to increase membership were not solely self-serving for super funds:

> A key component of a fund's management is a retention strategy as part of its business plan. When APRA conduct an on-site review of a fund, the first thing they say is, 'Show us your trust deed and your business plan.' So APRA is quite interested in seeing that a fund, as a matter of prudential management, conducts a strategy to retain and grow its membership.[23]

Disclosure of advertising costs

3.26 Other witnesses, while not arguing against advertising by funds per se, were unconvinced of the utility of it, and saw wisdom in requiring full disclosure to investors. The FPA was typical in expressing this sentiment:

> We do not necessarily have a problem with advertising per se. We are simply saying that we do not necessarily think it is actually part of a super fund's obligations, but if you want to advertise and if you have a cost allocated to it and if you are able to pay for it then at least members ought to know what that cost is and they need to accept that that is a cost. You can argue the toss as to whether it is education, promotion or otherwise as long as members first and foremost are aware of that cost and accept it. I would question whether a lot of the advertising is about education, because it is a very competitive market out there.[24]

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21 Dr Michaela Anderson, Director, Policy and Research, ASFA, *Committee Hansard*, Sydney, 24 October 2006, p. 33.

22 Mr Frank Gullone, Chief Executive Officer, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 13.

23 Mr Paul Collins, Manager, Legal Services, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 16.

24 Ms Jo-Anne Bloch, Chief Executive Officer, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 40.

3.27 The Investment and Financial Services Association (IFSA) was similarly circumspect, hinging its support for advertising on full accountability. It concluded that advertising should be clearly permitted but that:

> …[advertising costs are] coming from the funds, and in good faith they are expending that money to get a bigger slice of the market, a bigger membership base, and they say they are getting economies of scale. If that does not happen, someone has to be brought to account.[25]

3.28 The tendency of some funds to incorporate advertising costs into other administrative expenses has led some in the industry to advocate separate disclosure. Professional Associations Superannuation Limited (PASL) was a case in point:

> I think the annual report should separately itemise a variety of different sorts of information, one of which would be advertising. I think it should be separately recorded, as should be details of any major contracts that are applicable. I think open disclosure of all information is the approach that we would prefer.[26]

3.29 Some witnesses considered audited financial statements to be a better alternative to the annual report as a means of disclosure, although variation in the content and specificity of financial statements was identified as a possible barrier to achieving complete transparency.[27] The Association of Financial Advisors suggested that the cost of all advertising and promotion should be stated in whole dollars at the start of the annual report.[28]

Committee view

3.30 The committee notes the widespread support for the trustees' ability to advertise using member funds and the main arguments used by respondents in support of their case. The committee notes broad consensus on the positive role of advertising to educate members about fund features. Increased advertising is an inevitable consequence of superannuation funds competing for business, which was the main objective of the Choice of Fund legislation. It is in relation to advertising and promotion for the purposes of retaining or attracting members that difficulties arise.

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25 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, Sydney, 24 October 2006, p. 105. See also Mr Terry Brigden, Member, Superannuation Committee, Law Council of Australia, *Committee Hansard*, 7 March 2007, Sydney, p. 64; Institute of Chartered Accountants in Australia, *Submission 43*, p. 7; CPA Australia, *Submission 65*, p. 8.

26 Mr Kevin Beasley, Chief Executive Officer, Professional Associations Superannuation, *Committee Hansard*, Melbourne, 6 March 2007, p. 10. See also Ms Susan Ryan, President, Board of Directors, Australian Institute of Superannuation Trustees, *Committee Hansard*, 25 October 2006, Melbourne, pp. 85-86; Dr Peter Burn, Associate Director, Public Policy, Australian Industry Group, *Committee Hansard*, 7 March 2007, Sydney, p. 70.

27 See, for example, Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 5.

28 Association of Financial Advisors, *Submission 62*, p. 10.

APRA's view contrasts with the view of the majority of submitters, many of whom are actively engaged in advertising and promotion with the stated purpose of achieving economies of scale through the attraction of new members.

3.31 The committee can see merit in both approaches to the issue, and suggests that the regulator and industry might find common ground in compulsory and specific disclosure by funds of expenditure on advertising and promotion. One approach explored briefly by the committee focused on the possible relevance to the superannuation industry of Australian accounting standards. To this end the committee wrote to the Australian Accounting Standards Board (AASB) seeking information on whether it was developing an accounting standard for the not-for-profit sector. The committee asked how a proposed standard would apply specifically to promotional advertising, sponsorship and executive remuneration. The committee also wrote to ASFA asking whether any peak superannuation industry bodies had been involved with the AASB in developing a not-for-profit sector standard.

3.32 The AASB responded by informing the committee that its Accounting Standards are 'transaction neutral', requiring the same treatment for like transactions by all for-profit and not-for-profit entities, including public sector entities. It noted that the treatment of promotional advertising, sponsorship and executive remuneration in the not-for-profit sector would be accounted for and disclosed in accordance with the requirements in AASB 101, *Presentation of Financial Statements*, and AASB 124, *Related Party Disclosures*. The AASB noted further that it is currently reviewing AAS 25, *Financial Reporting by Superannuation Plans*, issued in March 1993 as a 'one-stop-shop' for financial reporting by superannuation plans. The AASB has agreed that that any replacement standard for AAS 25 should apply to all superannuation plans, irrespective of whether the plan, its trustee or its responsible entity is regarded as for-profit or not-for-profit.[29]

3.33 The AASB has not considered the accounting treatment and disclosure of promotional advertising, sponsorship expenses and executive remuneration by superannuation plans, but expects to sometime in the future:

> To date, the AASB's deliberations in relation to superannuation plans have focused on the measurement and disclosure of assets held by superannuation plans and pooled superannuation plans. Considering the increased emphasis now being placed on the disclosure of fees and charges by superannuation plans, the disclosure of promotional advertising and sponsorship expenses and executive remuneration is a topic that the ASB will need to address in its future deliberations.[30]

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29 AASB, correspondence, 18 April 2007.

30 AASB, correspondence, 18 April 2007.

3.34 ASFA also responded to the committee's request for information on this issue, noting that it has been actively involved in the current review of AAS 25 through its nominee on the AAS 25 Expert Advisory Panel.[31]

Recommendation 4

3.35 The committee recommends that peak superannuation bodies and APRA continue to work with the Australian Accounting Standards Board with a view to forming appropriate compulsory accounting and disclosure by all funds for promotional advertising, sponsorship expenses and executive remuneration.

'Not for profit' funds and service providers

3.36 The committee examined whether industry funds using the phrase 'not for profit' is legitimate in the context of their contractual arrangements with service providers. Other phrases commonly used are 'all profits go to members', 'run only to profit members' and 'profit for members'. Administrators, fund managers, and insurers are examples of service providers remunerated by superannuation funds.[32]

3.37 The Institute of Chartered Accountants in Australia described 'not for profit' and related terms as 'misnomers':

> These terms are misnomers as all superannuation funds pay for administration, investment and other services. The difference between funds is whether the entity being paid for providing these services is related or unrelated.
>
> A superannuation fund which is a product offered by a listed entity frequently engages related companies as its service providers. The profits of the listed entity would include those of all of its trustees together with its related service providers. By contrast, where an industry or corporate fund engages service providers, these are more likely to be unrelated. However these arms-length service providers fees would also include a percentage of profit for the owners of the service provider. Thus the fees of all superannuation fund trustees would include elements of ‘profit’, regardless of whether they are classified as retail, corporate or industry funds.[33]

3.38 Mr Steve Blizard from Roxburgh Securities argued that industry funds:

> ...choose to utilise the concept of “no one makes any profit – but the members”.
>
> This may be true, after all the other participants contracting to the Industry Super Funds have taken <u>their</u> profits. Some serious questions need to be asked about who is making money out of the Industry Super Funds?

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31 ASFA, correspondence, 30 April 2007.

32 FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 41.

33 Institute of Chartered Accountants in Australia, *Submission 43*, p. 7.

> The Industry super funds generally contract out the services of numerous Investment Managers, Auditors, Lawyers, Asset Consultants and Administration Service Companies.[34]

3.39 However, ASIC said that the use of the term is legitimate in the context of a superannuation trustee without responsibilities to shareholders:

> When used in a corporate context, 'not for profit' does not mean that it does not make a profit. It means that profits are not distributable to shareholders, either by way of dividend or in the event of a winding-up. That is the well-established meaning of the term. I think we are talking about net profits in all of those circumstances, which are the profits after all of the costs of administration. In a sense, it is not inherently misleading for a superannuation trustee entity that does not have external shareholders to whom dividends are payable to describe itself as not for profit in a way that would not be open to an ordinary, say, publicly owned company.
>
> I see nothing inherently misleading about that, nor is that general perception undermined by the fact that, along with the rest of the superannuation industry, payments are made to third-party service providers.[35]

3.40 The submission from ISN offered a more forthright assessment:

> It is ludicrous to suggest that industry super funds are not entitled to use such terms because businesses providing funds with services generate a profit from that business.[36]

3.41 The more salient issue relates to the propriety and transparency of these arrangements; in particular related party arrangements where a competitive tendering process for service provision has not been undertaken. Section 52(2)(c) of the SIS Act requires superannuation trustees to act in the best interests of their members. Consequently, the relevant question to be considered is as follows: is the related party agreement an arms length commercial arrangement or is the superannuation trustee being overcharged for the provision of services?

3.42 IFSA commented that the potential for excessive payments to service providers was equally applicable to all superannuation funds:

> Fees paid in a superannuation context eventually end up in the hands of individuals, whether shareholders, employees, or service providers further down the chain. The fundamental issue and responsibility of trustees is not whether the remuneration paid is "for profit" or "non-profit", but rather whether it is "reasonable" or "excessive" reward for the activities performed for the fund. The principle that the trustee act in the best interests

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34 Mr Steve Blizard, *Submission 3*, p. 10.

35 Mr Malcolm Rodgers, Acting Commissioner and Executive Director, Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, pp. 64-65.

36 ISN, *Submission 77*, p. 15.

> of members is enshrined in law. “Not for profit” entities can pay excessive rewards for services just as much as “for profit” entities.[37]

3.43 The committee heard that transparency and disclosure were key factors in determining whether or not trustees were acting in their members' best interests on this issue. The Law Council of Australia told the committee that 'not-for-profit' funds needed to exercise care when disclosing third party transactions:

> Certainly it is true that, if you do have a related service provider providing administration or other services, I think that has to be disclosed. It is part of a cost of a fund. Also, if a trustee is doing it internally it would be purely on at least a cost recovery basis if you assume it is not for profit. If a third party is doing it, whether they are related or not, that immediately raises the question of whether they are doing it on just a cost recovery basis or for cost recovery plus profit. If a related party is doing it on profit then I think you do have to be careful about how you explain that. I think if you then said, ‘Yes, we are not for profit,’ without a qualification, that could arguably be misleading.[38]

3.44 FPA was one organisation that suggested a lack of transparency existed over arrangements between trustees and service providers:

> The relationship between many Industry Funds and their service providers is an issue of concern for financial planners advising clients due to the lack of information available and the apparent lack of “arms length” contractual arrangements and detailed disclosure of these arrangements.[39]

3.45 In evidence, IFSA told the committee that the importance of superannuation warranted a consistent approach to disclosure:

> We are talking largely about public money, public savings, and the requirements that apply to public companies in relation to disclosure, and those requirements should apply in a superannuation context regardless of whether the entity that is the trustee is a public company or not.[40]

3.46 However, Mercer Human Resource Consulting warned the committee that more onerous disclosure requirements might impose unnecessary costs:

> I would not have a problem if trustees were required to disclose some of their related parties, where that impacts on the particular fund. I am just concerned that, if we go too far down the track in treating trustees as public companies, there are a lot of unnecessary additional costs that would not

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37 IFSA, *Submission 60*, p. 32.

38 Law Council of Australia, *Committee Hansard*, 7 March 2007, Sydney, p. 61.

39 FPA, *Submission 38*, p. 15.

40 Mr David O'Reilly, Policy Director, IFSA, *Committee Hansard*, 24 October 2006, Sydney, p. 103.

> necessarily relate to an improvement in disclosure that is relevant to members.[41]

3.47 Australian Industry Group also questioned the relative merit of more rigorous disclosure in this realm:

> ...where does it end, how much information are you providing, what is the integrity of the information and what is the utility of the information? People can sit around and think of lots and lots of things where there are small risks and they can impose significant costs on people to address those small risks and feel good about it.[42]

3.48 Reflecting concerns over funds advertising their 'not for profit status', FPA stressed that full disclosure was important to clarify these relationships:

> ...a number of services delivered to those not-for-profit funds are necessarily delivered by service providers who do make a profit. We think that there is some confusion out there between what really is not for profit within a super fund and some of the service providers providing services to those particular super funds. We do not argue with the status. We simply say that the related parties should be disclosed and that the relationship should be understood, because we think that there is some confusion.[43]

3.49 However other organisations told the committee that the framework for properly monitoring these arrangements is already in place. APRA told the committee that the licensing process compelled the disclosure of related party transactions:

> ...for any of those sorts of arrangements, the trustees are expected to be able to show that they had formal arrangements in place, that there were termination dates, how they chose particular service providers and so on. So the process [is] no different between a retail, an industry or a corporate in that sense.[44]

3.50 The Australian Institute of Superannuation Trustees stated that accounting standards dictated they must be disclosed already:

> ...there is full disclosure on related party transactions in the audited accounts of every fund, to which every member has access. That is a requirement of the law from an accounting standard point of view.

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41 Mr John Ward, Principal and Manager, Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, p. 66.

42 Dr Peter Burn, Associate Director, Public Policy, Australian Industry Group, *Committee Hansard*, 7 March 2007, Sydney, p. 67.

43 Ms Jo-Anne Bloch, Chief Executive Officer, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 41.

44 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 99.

> Members can get access to that if they so choose. It is no different from a public company.[45]

3.51 This was confirmed by CPA Australia, with the caveat that more prominent disclosure is not always beneficial to members:

> It is in the financial statements. The super funds et cetera pick up all of the normal accounting standards that would apply to any other entity plus whatever is in AAS25. So the related party disclosures, the remuneration issues and all those sorts of things are sitting in the financial statements for the super funds, which do not necessarily get sent in full to the members but the members are told in the annual report that they can request the full set. So the information primarily is there. In theory, disclosure is good, but a lot of disclosure can create unnecessary noise, and it is a question of whether the noise is going to add any value or whether the disclosure is going to add any value or is it just going to add noise?[46]

3.52 ISN maintained that industry funds disclose all service fees and related party transactions:

> As industry super funds grew, they identified many areas where the services they were obtaining from third party providers were overpriced or underperforming. As a result, industry super funds have used their collective scale to renegotiate the terms on which business is conducted in the industry or to create businesses which aim to provide superior service delivery to the funds or their members or provide services at a lower cost. Some of these collective vehicles also provide investment opportunities for the funds.
>
> Where these collective vehicles are owned by the industry super funds, profits which are generated are returned to the superannuation funds, either through dividend payment or capital appreciation and are disclosed in the funds' annual reports along with all the other fund investments.[47]

3.53 Another suggestion to ensure members do not pay excessive rates for fund services is to mandate a competitive tendering process for service provision agreements. SuperRatings expressed the view that competitive tendering ought to be mandatory, otherwise the market rate for such services cannot be satisfactorily determined on behalf of members:

> ...every trustee company should tender every service to the market on a regular basis to ensure that the members are receiving the best benefits. A trustee director's responsibility or fiduciary responsibility is to act in members' best interests at all times. What has happened historically, until

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45 Mr David Coogan, Treasurer, Board of Directors, Australian Institute of Superannuation Trustees, *Committee Hansard*, 25 October 2006, Melbourne, p. 82.

46 Ms Noelle Kelleher, Member, Financial Advisory Services Centre of Excellence, CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 61.

47 ISN, *Submission 77*, p. 15.

> we have shaken some funds up more recently, is that they have had the one administrator, they have had the in-house investment team, and they have had the in-house insurance arrangement. Our comment to them has been, 'How do you know that that insurance arrangement cannot be improved upon significantly externally?
>
> ...
>
> There is no way that a board can satisfy themselves that it is competitive without knowing what the other parts of the market are doing. In a lot of cases, they have been reluctant to do that. It is across the board. The report that we are currently running on eligible rollover funds, which account for something like $5.5 billion, has found that there is huge evidence of related party transactions in that specific area, and that is disappointing.[48]

3.54 It indicated that the problem was particularly acute with eligible rollover funds, given they are primarily comprised of lost members who will not scrutinise fee levels.[49]

3.55 APRA told the committee that competitive tenders are not compulsory, but are 'strongly suggested':

> We have not said, 'If you do not do it, you are in trouble.' All that we have said is that it would be good practice. But the more fundamental tests are: how are you able to determine, given your fiduciary obligations, that whatever you are proposing is in the best interests of the members; having chosen a service provider, what kind of arrangements are you putting into place; what kind of pricing have you obtained and should things go wrong—and we are talking about operational risks here—which will happen from time to time, what are your remediation control measures? We even ask, 'What would be your termination arrangements and, should termination occur, how would you make sure that ongoing service to the members takes place?' Those tests are common across the industry.[50]

3.56 APRA emphasised the importance of funds meeting the objective of getting the best deal for their members.[51]

3.57 The Australian Institute of Superannuation Trustees indicated that tendering was not critical as long as APRA's requirements are met:

> ...there is an outsourcing standard as one of the requirements of APRA's licensing, and in those outsourcing standards, it does not matter what type

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48 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 9.

49 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 9.

50 Mr Senthamangalam Ventkatramani, General Manager (Central), Specialised Institutions Division, APRA, *Committee Hansard*, 7 March 2007, Sydney, pp. 99-100.

51 APRA, *Committee Hansard*, 7 March 2007, Sydney, pp. 100-101.

> of fund you are, you need to set out the procedures for reviewing and monitoring all services providers. It really applies to both areas of the market, and it is up to the trustees to work their way through that as they see fit.
>
> Some trustees will put out to tender; they will have a tendering policy across their different service providers and set out a program for all service providers over a period of time. Others, given the nature of the service and because they have done benchmarking to satisfy themselves that they are getting the right service at the right sort of market rates, that they are not out of the market, they may choose not to go to tender as such.[52]

Committee view

3.58 The committee agrees with ASIC's statement that the use of the 'not for profit' label is not misleading as a consequence of payments to third party service providers being made. Paying for services essential to the running of a superannuation fund is a normal cost of administration incurred before net profit, which if directed back into the fund justifies the term's use.

3.59 From the committee's perspective the issue of whether members are getting a reasonable deal on these transactions is more significant. It is imperative that related party transactions for the provision of services are conducted at arms length and that overpricing is not occurring. This applies to funds of all types, not only the 'not for profit' industry funds.

3.60 During the inquiry the committee received no evidence of impropriety in relation to related party service agreements. However, it notes that the issue was raised with Industry Super Network (ISN) at a hearing in Melbourne on 6 March 2007, in the context of administration services provided to a large number of industry funds by Industry Fund Services Pty Ltd. The main issue discussed was whether there is adequate transparency and disclosure of these third-party relationships.[53] It followed concerns previously raised by former Chief Executive Officer of the Association of Independently Owned Financial Planners, Mr Peter Johnston, and others about whether members of industry funds were informed about the income derived by Industry Fund Services Staff Equity Trust (IFS-SET) from its extensive involvement in the administration of their superannuation savings, and how that income was disbursed. These concerns were also raised by Senator Chapman in the Senate on 24 June 2004.[54]

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52 Mr David Coogan, Treasurer, Board of Directors, Australian Institute of Superannuation Trustees, *Committee Hansard*, 25 October 2006, Melbourne, p. 83.

53 *Committee Hansard*, 6 March 2007, Melbourne, pp. 21-25.

54 Senator Chapman, 'Industry Funds Services Pty Ltd', *Senate Hansard*, 24 June 2004, pp. 25293-96.

3.61 At the hearing, ISN spokesperson, Mr Garry Weaven, tabled a document responding to claims of a lack of transparency in the relationships between industry funds and Industry Fund Services. It concluded by noting: 'The industry superannuation fund network has consistently argued for maximum disclosure of fees and charges of superannuation funds and for the outlawing of sales commissions in the selling of compulsory superannuation as a precondition for a successful choice of fund regime'.[55]

3.62 To assist the committee, ISN agreed to take on notice questions arising from the hearing. However, the committee is concerned that ISN subsequently declined to provide any responses that might have provided a better understanding of the mutual structure and operation of superannuation funds within ISN. ISN representatives were the only witnesses to the inquiry who explicitly refused to supply the committee with further information when requested. The decision by ISN not to provide answers to the Chair's questions was unhelpful and therefore fails to allay concerns about the cost of third party transactions with service providers. The committee is concerned that fund members are not fully informed when it comes to investing their superannuation savings if industry funds are not disclosing the true cost involved in their administration. Senator Chapman's Adjournment speech of 24 June 2004, ISN's tabled response and the committee's questions on notice to ISN are included in Appendix 4.

3.63 Notwithstanding these concerns, it is not apparent to the committee that the current framework fails to ensure that trustees overall are not acting in their members' best interests when making these arrangements. Accordingly, the committee makes no recommendation for legislative change in this area. It does reiterate, though, that trustees of superannuation funds should continue to exercise caution in this area and continue to tender out service provision agreements wherever possible.

Recommendation 5

3.64 The committee recommends that the government formulate and implement an effective disclosure policy for both product disclosure statements and annual reports to address any deficiencies in reporting related party transactions.

Recommendation 6

3.65 The committee recommends that trustees of superannuation funds publicly tender key service provision agreements.

Regulatory overlap

3.66 The committee was informed of overlapping regulatory responsibilities, which have resulted in a duplication of compliance tasks and increased business costs.

55 Response to Speech of Senator Grant Chapman incorporated in Hansard – 1.56am, 24 June 2004. made on behalf of Garry Weaven, Executive Chair, Industry Fund Sendees Pty Ltd (IPS) and Mr Sandy Grant, Managing Director of IPS.

Organisations complaining of the problem cited the potential for an improved delineation of regulatory responsibilities, as well as deficiencies in communication and information-sharing between regulators, as the main contributing factors.

3.67 IFSA outlined the duplication of administrative effort caused by regulatory overlap, questioning whether it is matched by any regulatory benefit:

> With five regulators (APRA, ASIC, ASX, RBA and ACCC) responsible for various aspects of regulation of the investment and financial services industry the efficiency of both regulation and the industry is dependent on a clear delineation of responsibilities. When each regulator develops and pursues their individual objectives without cognisance of the others requirements overlaps, duplication and conflicts are inevitable.
>
> Each regulator may claim that their individual requirements are justified given their unique objectives but the industry is entitled to question whether any additional public benefit that might be derived from a duplicated requirement is not outweighed by the complexity and inefficiency it introduces when the core objectives are already achieved by another regulator's more general requirements.[56]

3.68 CPA Australia commented on the communication deficiencies between regulatory agencies that request similar information:

> The main issue is the level of duplication and the apparent lack of coordination or consistent interpretation between the regulators. Both APRA and the ATO regulate superannuation funds under the SIS Act. Yet their interpretations can vary widely, for example, the definition of fund rules. Similarly, trustees had to provide similar information to ASIC and APRA to apply for their AFS and RSE licenses, yet there was very little information shared between the regulators.[57]

3.69 Superpartners contended that the practical distinction between the roles of ASIC and APRA had become 'blurred':

> Consumer protection overlaps with prudential management and risk control. This is because consumer protection not only involves protection at point of sale (making an informed decision to invest) but also extends to ensuring the safety of the consumer's investment. The safety of an investment in turns depends on the integrity of the risk controls (APRA) and the effectiveness of corporate governance (ASIC).
>
> ...
>
> In recent times, the distinction between ASIC and APRA functions has become more obscured with the ASIC licensing regime extending to superannuation funds, rather than exempting funds to remain under full APRA supervision. While risk management of a superannuation fund is

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56 IFSA, *Submission 60*, pp. 11-12.

57 CPA Australia, *Submission 65*, p. 4.

> regulated by APRA, risk management of a managed fund is regulated by ASIC. Corporate governance of a non-superannuation corporation is governed by ASIC while a superannuation fund must comply with APRA-regulated rules of fitness and propriety for directors and Board equal representation as well as complying with the ASIC corporate regulation (in the case of corporate trustees).[58]

3.70 AXA commented on the practical inefficiencies caused by ASIC and APRA's dual regulatory responsibility over superannuation funds:

> On several occasions over the last twelve months, AXA has provided large volumes of material relating to our superannuation funds and the trustees to one regulator, and then provided the same material to the other regulator at a later date.[59]

Breach reporting

3.71 More specifically, a common complaint was the differing breach reporting requirements under both the AFS and RSE licensing regimes overseen by ASIC and APRA respectively.[60] ASFA told the committee that the absence of a materiality threshold for APRA-related breaches is problematic:

> ...on the APRA side is that in particular there is no materiality threshold as there is on the Corporations Act side. ...The lack of a threshold means that the regulator runs the risk of being swamped with a large number of non-material, non-significant breaches being reported. Questions that get discussed range from the ridiculous to the sublime, such as, 'Do I have to report a spelling mistake in a product disclosure statement?' I know that people kind of laugh it off, but people are actually discussing those kinds of things in this area.[61]

3.72 AXA also complained of being required to report breaches of the Corporations Act to both regulators, citing it as an example of a lack of co-operation between them:

> A trustee's obligation to report breaches of the law to APRA under the RSE licence include breaches of a range of Corporations Act provisions, breaches of the SIS Act and breaches of the Financial Sector (Collection of Data) Act. Such breaches must also be reported to ASIC. Aside from the cost of reporting an issue, in different forms, to each of the two regulators, compliance costs are compounded by the different approaches taken by

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58 Superpartners, *Submission 67*, pp. 26-27.

59 AXA Asia Pacific Holdings, *Submission 45*, p. 12.

60 See for example ASFA, *Submission 68*, p. 33.

61 Dr Bradley Pragnell, Principal Policy Adviser, ASFA, *Committee Hansard*, 24 October 2006, Sydney, p. 22.

each of the regulators to the ongoing reporting and rectification requirements relevant to the reported matter.[62]

3.73 Industry Funds Forum told the committee of the costs of duplication in this area:

> The duplication of trustee obligations to report breaches to ASIC and APRA adds significantly to compliance costs. In addition the absence of any materiality limitation on breaches to be reported to APRA is onerous and costly. [63]

A single regulator for superannuation?

3.74 A number of submitters argued that a single regulator overseeing a single licensing regime should have responsibility for superannuation.[64] RCSA and PASL stated:

> It is our opinion that there should be one regulator for all funds including SMFs, with the ATO maintaining a role confined only to the taxation aspects of the superannuation system. This would result in a far less complicated and less costly compliance environment.
>
> It would also be less confusing for the membership in circumstances where there is a complaint in respect of a fund. At present there is a lot of confusion as to which regulator a disgruntled member can approach for a solution.[65]

3.75 Superpartners also recommended that the two regulators be merged:

> With their repeated overlap in functions, there should be no cultural reasons against merging the two regulators. The two regulators have a fundamental common purpose of protection of the public and promoting confidence in the Australian financial system. The case for merging ASIC and APRA into a single entity is compelling.
>
> While we recognise there have been efforts to reduce the regulatory overlap and clarify the demarcation between the two regulators, the fundamental issue of two regulators or one must be directly confronted. Any inquiry into the structure and operation of the superannuation industry cannot avoid consideration of this issue which goes to the heart of the effectiveness of superannuation regulation and the costs of compliance for participants in the industry.[66]

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62 AXA Asia Pacific Holdings, *Submission 45*, p. 13.

63 Industry Funds Forum, *Submission 73*, p. 37.

64 See for example Industry Funds Forum, *Submission 73*, p. 37.

65 RCSA and PASL, *Submission 56*, p. 12.

66 Superpartners, *Submission 67*, p. 28.

3.76 Alternatively, despite its concern over regulatory overlap, IFSA expressed its support for the 'twin peaks' approach to regulating the industry:

> Our support is still for the twin peaks. The industry invested very heavily in the twin peaks, and in terms of our industry they have actually worked quite well. We have had some problems, but there has not been amongst our members any major failings, and investors in our industry have not lost money as a consequence of poor regulation. Yes, we did have HIH, but that has gone on and we have now changed certain arrangements to better protect the general insurance industry. Our position remains that we have two regulators.[67]

3.77 It added that an amalgamation of ASIC and APRA could produce detrimental regulatory outcomes:

> The...point about moving to a single regulator from two is the risks you have during the transition. Regulators have a whole culture of having an eye on the ball, people not worried about their jobs tomorrow or whether they are moving from Canberra to Sydney, and some say that the HIH failure was a failing of the fact that we moved the ISC into APRA. So we have to be very careful in making massive movements in terms of regulator change.[68]

Other suggested remedies

3.78 Those who identified problems with regulatory inefficiencies, but did not advocate amalgamating regulatory agencies, offered a number of other suggestions to improve the present situation. These generally focused on legislating to clarify responsibilities and adopting better administrative practices to ensure agencies share information that is supplied on multiple occasions.

3.79 IFSA suggested that:

> ...the Government...control the proliferation of regulatory duplication, overlaps and conflicts by legislating to provide a primary set of responsibilities for each regulator and requiring them to rely on regulation by other regulators where they do not have that primary responsibility.[69]

3.80 In evidence IFSA described this arrangement in terms of establishing a 'lead regulator' where two agencies have responsibility over the same area of the law.[70]

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67 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, 24 October 2006, Sydney, p. 98.

68 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, 24 October 2006, Sydney, p. 99.

69 IFSA, *Submission 60*, p. 12.

70 Mr David O'Reilly, Policy Director, IFSA, *Committee Hansard*, 24 October 2006, Sydney, p. 98.

3.81 CPA Australia indicated that better cooperation between the regulators is needed:

> ...we had Australian finance services licensing two or three years ago and we have just gone through the two-year transition period for trustee licensing under APRA. There were a lot of the same questions and a lot of the same requirements, although perhaps couched a bit differently. The trustees had to jump through the same hoops again, providing the information to APRA, when a lot of it could have been shared in the first place. Because we have that separation, we end up with a lot of duplication. There does not seem to be as much cooperation between the three regulators as there could be.[71]

3.82 Although calling for an amalgamation of agencies in the long term, AXA suggested a multifaceted approach focusing on improved cooperation in the short term:

> The longer term solution to this issue is to move to a single regulator of financial services, combining the roles currently undertaken by APRA and ASIC. In the medium term, greater differentiation of the roles and responsibilities of the two regulators and a reduction in the amount of dual regulation would be helpful.
>
> In the short term, significant reductions in compliance costs could be achieved through greater co-operation between the regulators and a combined approach by the regulators to their dealing with entities, including:
>
> - co-ordination of regulatory activities and calendars
> - joint conduct of reviews where responsibilities overlap
> - streamlining of policies relating to common areas such as outsourcing, responsible persons/officers and whistleblowing
> - sharing of information and greater co-operation between the regulators.[72]

3.83 The framework for cooperation between ASIC and APRA is set out in their 1998 Memorandum of Understanding (MOU). The provisions of the agreement include:

> A joint Co-ordination Committee will be established to facilitate close cooperation between APRA and ASIC. The Committee will operate according to a Charter and be responsible for ensuring the appropriate arrangements are in place for matters such as co-ordinating information sharing, joint inspections or task forces, referral of cases and enforcement action or major supervisory intervention. It will also co-ordinate operational

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71 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 59.

72 AXA Asia Pacific Holdings, *Submission 45*, p. 12.

> matters such as administrative arrangements to avoid duplication, statistical collections, joint research work or training or industry consultation, and participation in international fora.[73]

And:

> The agencies agree that, subject to legislative provisions, information available to one agency, which is relevant to the responsibilities of the other agency, will be shared as requested. Each agency will provide relevant information to the other on a best endeavours basis, with due regard to the urgency of doing so. This will be subject to any relevant legal and operational considerations and any conditions which the provider of the information might place upon the use or disclosure of the information, such as claims of legal professional privilege.[74]

3.84 On the more specific issue of breach reporting, contributors to the inquiry called for specific legislative change to achieve consistent materiality thresholds and avoid reporting a breach to both APRA and ASIC.

3.85 On materiality, Mercer suggested:

> We recommend that ASIC and APRA work together to develop a standard definition of 'materiality' for the purpose of breach reporting, and implement a streamlined breach reporting process, to minimize compliance costs to the industry.[75]

3.86 The Australian Bankers' Association (ABA) submitted that:

> We support the concept of consistency in breach reporting arrangements, i.e. what must be reported and when it must be reported. However, there should be recognition of the different regulatory objectives and supervisory methods of the two regulators. Therefore, we suggest that a section 912D-type regime be extended to APRA regulated superannuation entity licensing, where requirements align based on significance and materiality. It would be useful for ASIC and APRA to provide procedural guidelines or a checklist.[76]

3.87 It suggested a 'materiality test broadly consistent with the ASIC administered definition of "significant", but with a prudential emphasis'.

3.88 AXA recommended an exemption for trustees from the dual licensing regime to avoid duplication:

> The most effective way to address the cost of dual licensing is to remove the requirement for trustees of public offer superannuation funds to be

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73 Memorandum of Understanding between APRA and ASIC, October 1998, Paragraph 5.1.

74 Memorandum of Understanding between APRA and ASIC, October 1998, Paragraph 6.3.

75 Mercer Human Resource Consulting, *Submission 71*, p. 21.

76 Australian Bankers' Association, *Submission 88*, p. 18.

> licensed by ASIC to deal in financial products (a minor amendment to Corporations sub regulation 7.6.01(1)(a)). This would eliminate the duplication without reducing the effectiveness of the regulation of these entities. Importantly, a trustee of a superannuation fund would still be obliged to comply with the relevant provisions of the Corporations Act even if it was not licensed under the Corporations Act.

3.89 It added that such a proposal would be workable with requisite co-operation between the regulators:

> Reporting the breach of a Corporations Act requirements [sic] to APRA (as is currently required) will enable effective and efficient regulatory supervision – either directly by APRA or by referral of the breach to ASIC. The mechanism for this co-operation already exists under the Memorandum of Understanding between the two regulators. The failure of the two regulators to co-operate has been the subject of industry criticism, and the duplication of reporting required by the current legislation is evidence of this lack of co-operation.[77]

3.90 APRA informed the committee of legislative change to address inconsistencies in breach reporting requirements.[78] The committee notes that the government has responded to this issue in its December 2006 proposals paper on 'streamlining' prudential regulation.[79] It contains two proposals particularly relevant to the criticisms heard by the committee:

- the inclusion of a materiality test for reporting breaches of prudential regulations, bringing these requirements into line with the test under section 912D of the Corporations Act for reporting breaches to ASIC; and
- legislative amendments to ensure regulatory breaches currently required to be reported to both ASIC and APRA need only be provided to APRA, which would then provide the information to ASIC.[80]

APRA response

3.91 Firstly, the committee notes the government's endeavours to reduce the regulatory burden of overlapping regulatory responsibility through the process currently being undertaken, as mentioned above. However APRA also expressed the opinion that the problem was not of overwhelming significance and that some overlap is necessary, given the legislative arrangements.

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77 AXA Asia Pacific Holdings, *Submission 45*, p. 13.

78 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 102.

79 Treasury, *Streamlining prudential regulation: response to 'Rethinking Regulation'*, December 2006.

80 Treasury, *Streamlining prudential regulation: response to 'Rethinking Regulation'*, December 2006, pp. 1-2.

3.92 APRA told the committee:

> ...when we began the superannuation licensing one of the very first things we did in establishing a process was to get in touch with ASIC to see the extent to which we could use all the information that they collected for their licensing regime. From memory, we found there was only an overlap of 15 to 20 per cent in our population, because many of our licensees are not public companies, so the licensing was different. So for starters we then had to devise our own licensing system.[81]

3.93 It also indicated that with respect to enforcement, involvement by both regulators is be inevitable:

> ...some entities have said, 'Well, we've got APRA and ASIC knocking on our door.' And the answer is, 'Yes, you do, because we deal with different pieces of legislation.' In an enforcement matter it may well be that we are looking at two different types of breaches of different laws. So, yes, APRA enforcement and ASIC enforcement may be there.[82]

Committee view

3.94 The committee does not support merging regulatory agencies to address problems that can be improved substantially through minor legislative amendments and better inter-agency cooperation. It is of the view that the government's proposals to streamline prudential regulation are a positive move to reduce regulatory inefficiency. The proposals referred to above appear to address the same concerns that were most prevalent during the inquiry. As such, the committee recommends that those proposals be implemented through legislation.

Recommendation 7

3.95 The committee recommends that the government's proposed measures to simplify breach reporting be implemented through legislation.

3.96 The committee recognises the strength of feeling in a number of witnesses concerning overlapping, inconsistent and conflicting requirements from a number of regulators. These concerns need to be heeded. The committee is of the view that with respect to APRA and ASIC there are greater advantages to their separate identity as agencies than to their potential amalgamation. However, with respect to their functions the committee has no in-principle objection to functions being reallocated to one or the other, or harmonised in some way. Accordingly, the committee believes that Treasury should report to the government on matters raised in evidence that relate to this issue.

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81 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 110.

82 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 110.

Recommendation 8

3.97 The committee recommends that Treasury examine and report to government on the issue of overlapping, inconsistent and conflicting requirements of superannuation funds from a number of regulators.

Chapter 4

Member investment choice and the role of the trustee

4.1 A major issue considered by the committee during the inquiry was the extent to which superannuation savings are adequately safeguarded under the existing prudential framework, and whether potential risks to the safety of superannuation savings are adequately covered in the current regulatory environment. The committee strongly believes that ensuring the safety of retirement savings should be a fundamental objective of any pension or superannuation regulatory regime.

4.2 In this chapter and the next the committee examines a number of issues that collectively address the broad theme of safeguarding superannuation savings. Chapter 4 specifically addresses terms of reference 5 and 6: the meaning of member investment choice and the responsibility of the trustee. It does so mainly from the perspective of the prudential standards with which funds comply; specifically, trustees' fiduciary responsibilities under the SIS Act and the Australian Prudential Regulation Authority's (APRA) interpretation of the act and SIS regulations and the guidance it provides to trustees.

Member investment choice

What is member investment choice?

4.3 Under a system of member investment choice, superannuation funds enable members to choose from a range of investments in major asset classes, combinations of asset classes and investment options. A trustee may be instructed by a member to follow a particular investment strategy which involves investing funds in a specific financial product, such as a managed investment scheme.[1] The investment option relates to a choice of investment strategies rather than a choice of specific investments. Each strategy must comply with the investment strategy required by section 52(2)(f) of the SIS Act. If a member's fund does not provide the type of investment option the members wants, the affected member is able to move to another fund with more suitable investment options.

4.4 Member investment choice is not a new concept. For over a decade investment choice has been the norm for accumulation funds. One recent estimate suggested that 89 per cent of superannuation funds offer investment choice to fund members. According to the Investment and Financial Services Association (IFSA):

> When combined with rapid technological advances and greater administrative efficiencies in the 1990s, member investment choice became part of the framework for the development and rapid growth of

1 It is important to note that a trustee cannot be bound by a direction from a member.

superannuation administration platforms that are offered mainly through licensed investment advisers.[2]

4.5 The number and types of choices, and how they are offered to members, have expanded over this period. Initially, funds offered limited choices of between three to five investment options. However, over time these options have become more sophisticated with funds offering their members as many as 50 or more investment options. APRA reported that as of June 2006 retail funds offered the greatest number of investment choices to members, with an average of 88 investment options per fund. This contrasts with industry funds that had an average of ten investment options per fund, and corporate and public sector funds that had an average of seven and six investment choices per fund respectively.[3] Table 1 provides a breakdown of investment choices as reported by APRA.

4.6 Some in the industry believe the proliferation of investment options is the best way to improve service delivery to consumers. Some funds are 'adding value' to their investment products by diversifying their investment menus and providing niche investment options.[4] The legislation, however, does not set any investment limits for funds of individual members.

Table 1: Investment choice by fund type as reported by APRA, year end June 2006[5]

Fund type	Corporate	Industry	Public sector	Retail	Total
Number of entities with more than four members	555	81	44	192	**872**
Number of entities offering investment choice	205	68	29	127	**428**
Proportion of entities offering investment choice	36.9%	84%	65.9%	66.1%	**49.1%**
Average number of investment choices offered per entity	6	10	7	88	**35**

2 IFSA, *Submission 60*, p. 20.

3 Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2006 (issued 22 March 2007), p. 6.

4 Choice, *Submission 75*, p. 7.

5 Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2006 (issued 22 March 2007), p. 37.

4.7 The industry recognises several distinct advantages in enabling fund members to choose their investment options. It enables them to better manage their investment approach and therefore minimise exposure to risk. It also enables members to move away from more conservative investment options that might provide low long-term average returns and give them a sense of ownership and control of their superannuation savings. Under member investment choice fund members bear the investment risk.

4.8 Evidence shows that fund members who do exercise choice are mainly high net worth individuals with large superannuation balances who are interested in their retirement savings.[6] However, while the opportunity for member investment choice is widespread in Australia, the evidence shows that the majority of fund members do not seek or exercise investment choice. According to industry research, over 80 per cent of fund members do not actively choose either investment or insurance options.[7] This figure increases to over 90 per cent for industry funds. In terms of total assets held by funds with more than four members, at 30 June 2006 48.8 per cent of assets ($318.7 billion) were held in the default investment strategy.[8]

4.9 In the majority of cases where member choice is not exercised, the members' account is invested in a 'balanced' default option. This raises a series of interesting issues relating to the meaning of investment choice, why it is not being exercised by most fund members, and the relationship between choice and the provision of appropriate and affordable financial advice (see the discussion of this complex issue in Chapter 6).

4.10 Major industry bodies were cautious about the alleged benefits to members of funds offering unlimited investment choices. According to the Association of Superannuation Funds of Australia (ASFA):

> In the absence of involvement of financial planners there are actually grounds for believing that the more investment choices that are available, the less likely a member is to actively exercise a choice. Research into consumer behaviour indicates that more choice above a certain level can lead to greater confusion and uncertainty, and this applies whether it is types of jam of coffee, or investment options within a superannuation fund.[9]

4.11 The ASIC submission pointed out that member investment choice triggers certain disclosure obligations under the Corporations Act that were introduced by the financial services reforms (FSR) to apply in addition to the specific SIS Act disclosure requirements. From 1 July 2007, the disclosure requirements have been modified

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6 Mr David Elia, Chief Executive Officer, HostPlus, *Committee Hansard*, 6 March 2007, Melbourne, p. 62.

7 SuperRatings, *Submission 49*, p. 6.

8 Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2006 (issued 22 March 2007), p. 6.

9 ASFA, *Submission 68*, p. 23.

modified to enable trustees to prepare product information about a specific financial product. This stands in contrast with the current arrangement whereby trustees are required to provide members with a product disclosure statement prepared by the issuer of the financial product.[10]

4.12 The committee notes that the superannuation industry is fully supportive of member investment choice. There does not appear to be support for mandating a default strategy for certain elements of retirement savings. The Financial Planning Association submission argued that mandating a default strategy would be counter-productive to enabling people to achieve their retirement saving goals.

4.13 Yet the committee finds that notwithstanding the advent of member investment choice, default investment options remain a critical component of the compulsory superannuation system. This is one of the main reasons why the role of trustees is critical to the long-term viability of the superannuation system.

4.14 APRA statistics show that, with respect to major superannuation funds, the proportion of total superannuation assets in the default investment strategy was 54.8 per cent in June 2006, although this is trending down. This means that less than half of all superannuation assets in major funds are invested on the basis of members exercising an alternative investment choice strategy.[11]

4.15 In the industry fund sector for example, where 99.2 per cent of assets are in entities offering investment choice, at an average of 9 options per entity, a higher than average 73.6 per cent of assets remain in the default setting. Alternatively, while a smaller proportion of retail fund sector assets are in entities offering investment choice (87.5 per cent), entities that do offer investment choices provide an average of 108 options. In this sector a smaller proportion of assets (42.4 per cent) remain in the default strategy.[12]

4.16 APRA's complete statistics on investment choice by sector and up to June 2006 are included in Appendix 5. Statistics presenting a breakdown of the asset allocation of default investment strategies by sector are also included in Appendix 5.

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10 ASIC, *Submission 48*, p. 14. The revised arrangements to take effect from 1 July 2007 are set out detail in ASIC Policy Statement 184, *Superannuation: Delivery of product disclosure strategies*.

11 APRA, *Insight*, 'Celebrating 10 years of superannuation data collection', Issue 2 2007, Table 13, pp. 55-56. Figures are for entities with at least $100 million in assets. The distinction between those who consciously decide to remain in the default setting and those who remain so because of disinterestedness in their investment strategy is not captured in the statistics.

12 APRA, *Insight*, 'Celebrating 10 years of superannuation data collection', Issue 2 2007, Table 13, pp. 55-56. Statistics for retail funds do not include eligible rollover funds, which do not offer investment choice.

The role of the trustee

4.17 The SIS Act includes provisions that deal with the prudent investment of superannuation assets. Members of superannuation funds face a number of investment risks; for example, the trustee failing to formulate an appropriate investment strategy, give due attention to diversification and comply with well-founded investment strategies. To address these risks, trustees are required to ensure that each investment option meets the requirements of the investment covenant at subsection 52(2)(f) of the SIS Act. The covenant requires the trustee:

> (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, 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; and
> >
> > (iv) the ability of the entity to discharge its existing and prospective liabilities…[13]

4.18 The trustee must also meet certain requirements under SIS Regulation r.4.02 when offering investment strategies in order to be protected under section 55(5) of the SIS Act against action by any members in relation to investment losses. These requirements include that the trustee must give members:

- the investment objectives of each of the offered strategies;
- information the trustee reasonably believes necessary for the member, or class of members, to understand the effect of, and any risk involved in, each of those strategies; and
- the range of directions that can be given to the trustee of their fund and the circumstances in which these directions can be changed.[14]

4.19 In respect of investment decisions, the SIS Act does not specify how trustees must give effect to the covenant. However, the Productivity Commission found that the act mostly codifies what a prudent trustee could be expected to do under general trust law. The Commission also found that the investment covenant may strengthen prudent management because it:

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13 *Superannuation Industry (Supervision) Act 1993*, subsection 52(2)(f).

14 Australian Institute of Superannuation Trustees, *Submission 79*, p. 21.

- provides the trustee with a clear statement of responsibilities which may assist their efficiency, because the 'tasks' have been spelt out;
- provides greater assurance that an appropriate investment strategy is formulated, implemented and reviewed; and
- provides greater transparency and certainty with respect to what must be done by a trustee.[15]

4.20 APRA's submission stated clearly that in offering investment choice to members, trustees must balance the objective of providing choice while ensuring they invest fund assets in a prudent and responsible manner in order to manage and minimise risk:

> …APRA does expect trustees to take responsibility for mitigating particular risks such as concentration risks and demonstrate that they have done so on an ongoing basis. In its prudential reviews, APRA seeks to understand how trustees have assessed such risks and addressed them in an acceptable manner.[16]

4.21 In March 2006 APRA issued a revised circular that provides trustees with guidance on how to discharge their duties as required by the SIS Act. Superannuation Circular II.D.1, *Managing Investments and Investment Choice*, explains the requirements of the SIS Act for managing investments and investment choice in APRA-regulated superannuation entities and, importantly, provides guidance to trustees on how APRA approaches its supervisory role in relation to these and some other investment-related matters.[17] It is the intersection of these two aims, in particular how the former has come to inform the latter, which has resulted in much confusion and concern within the superannuation industry over APRA's guidance (see the discussion from paragraphs 4.25 below).

4.22 According to the circular:

> Under the SIS Act, the trustee of a superannuation entity is solely responsible and directly accountable for the prudential management of the investment of the entity's assets. It is the trustee's duty to make, implement and document decisions about investing those assets and to carefully monitor their performance.[18]

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15 Productivity Commission, *Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, p. 127.

16 APRA, *Submission 51*, p. 8.

17 Australian Prudential Regulation Authority, *Superannuation Circular No. II.D.1: Managing Investments and Investment Choice*, March 2006. This updated version replaced an earlier superannuation circular on investment choice dated April 1999.

18 Australian Prudential Regulation Authority, *Superannuation Circular No. II.D.1: Managing Investments and Investment Choice*, March 2006, p. 4.

4.23 APRA stated that the guidance provided in the circular is not intended to significantly impinge on the choices that trustees can offer and members make: 'Rather, it focuses on trustee protection of members' interests by means of sound processes and policies to manage investment risk'. The circular goes on to state at paragraphs 38 and 39 that:

> Trustees of APRA-regulated funds that offer investment choice are expected to:
>
> - Recognise their statutory responsibility to set each investment strategy offered by the fund;
> - Consider the circumstances of the fund when formulating each investment strategy;
> - Ensure that appropriate controls are in place to manage risk, diversification and liquidity; and
> - Recognise that if it fails to fulfil its obligations, it leaves itself open to loss of the statutory defence available under s. 5595 of the SIS Act against claims for the investment losses.[19]

4.24 Notwithstanding APRA's guidance on member investment choice, opinions in the industry vary on the role of trustees in a member investment choice situation. There does, however, appear to be agreement that the trustee's role is primarily twofold: to facilitate the selection of investments by a member through provision of a 'menu' of investment option and make a default selection in circumstances where the member has either not provided investment instructions or is unable to do so. One of the key issues for trustees is managing investment risk for members.

Criticism of APRA's interpretation of investment choice

4.25 The need for regulatory clarity regarding the role of superannuation trustees was a consistent theme in evidence before the committee. This emerged as a key issue as a result of ambiguity in the interpretation of the trustee's obligations and members' responsibilities. There is, at least in theory, a dichotomy in the regulatory environment between permitting member choice of investment (with or without financial advice) and the requirement that the trustee must adopt an investment strategy for the fund as a whole. The issue was stated clearly by the Industry Funds Forum (IFF) submission:

> This dichotomy creates a conflict between the trustee's obligation to determine and accept total responsibility for the investment strategy, while at the same time allowing that strategy to permit members to direct the trustee how they wish to invest. APRA's interpretation in the Circular of how these two concepts interact is proving unworkable for some trustees of funds offering a wide range of investment choices.[20]

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19 Australian Prudential Regulation Authority, *Superannuation Circular No. II.D.1: Managing Investments and Investment Choice*, March 2006, p. 11.

20 IFF, *Submission 73*, p. 24.

4.26 Some submitters noted the potential for conflict between the need for trustees to maintain a responsible investment strategy and the impetus to provide investment choice. The issue was described clearly in evidence by Mercer Human Resource Consulting:

> We are in a choice environment. Members can choose their own fund. It seems anomalous that, whilst a member can choose his own fund, he cannot choose his own investment. In many cases, members have chosen a particular investment strategy on the advice of their own financial planner; yet here we have APRA saying it is inappropriate for that advice to be followed in a superannuation fund.[21]

4.27 Furthermore, some witnesses pointed out that conflict may arise when the investment choice facility is so broad it risks undermining the benefits of collective investment. As pointed out by the Corporation Superannuation Association:

> …there are concerns that if enough members…adopt a particular specialised approach involving a narrow class of shares, this could put the savings of other fund members at risk because of the requirement that the trustee re-balance the portfolio thereby reducing the exposure of the other members to the class of stocks specifically chosen by the narrow investment choice members.[22]

4.28 The tension between APRA and sections of the industry has centred on different interpretations of the law; specifically, over sections 52(4) and 52(2)(f) of the SIS Act. This tension is at the heart of debate over the regulation of member investment choice. For many within the industry APRA's circular has clouded the issue and fuelled concerns about the role of the trustee in formulating investment strategies especially where, as previously noted, members have received advice from a financial planner. There is a strongly held view within the industry that APRA's interpretation of the law extends the trustee's responsibility to the investment choices made by members on the one hand, yet ignores the availability of financial advice in a member investment choice situation on the other.[23] According to the IFSA submission:

> While there is much in the APRA circular with which the industry would agree, the critical differences revolve around an interpretation of the law that would effectively extend trustee responsibility to individual member investment choice and ignore the availability of financial advice in member investment choice.[24]

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21 Mr John Ward, Principal and Manager, Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2007, Melbourne, pp. 67-68.

22 Corporate Superannuation Association, *Submission 28*, p. 10.

23 MLC, *Submission 83*, p. 11.

24 IFSA, *Submission 60*, p. 22.

4.29 The IFSA submission argued further that APRA's views, as set out in the circular, are a departure from how the industry has come to interpret the relevant SIS provisions and have placed significantly more responsibility on trustees over and above the responsibility to offer and manage suitable investment strategies for members. Limitations placed on the investment choices made by members may result in regulated superannuation funds being at a competitive disadvantage to self-managed superannuation funds (SMSF) where there are no investment choice restrictions: 'As a result…some clients will transfer to a SMSF to create the flexibility they need to avoid what they and their advisers will perceive to be limited investment choice within a fund…'[25]

4.30 The Financial Planning Association of Australia (FPA) submission made a similar argument in noting the difficulty arising from APRA's view that trustees are generally unable to take into account individual advice provided to a member by a financial planner when developing an investment strategy for a fund. The advice from the financial planner may take into account the individual needs of the member including any other superannuation assets and the member's general retirement objectives:

> In the view of the FPA, this has the capacity to limit the operation of the government policy as embodied in Superannuation Choice and discourage members from taking an active interest in their financial future.[26]

4.31 Submissions from the Australian Bankers' Association (ABA) and the Law Council of Australia noted conflicting views within the superannuation industry about whether the trustee is restricted to offering investment strategies consistent with section 52(2)(f), or whether the trustee can accept directions relating to investment choices irrespective of the funds' investment strategies. The ABA stated emphatically:

> We are concerned that the interpretation of the law as contained in the circular would in effect extend trustees' obligations to individual members' investment choice. The formulation of the investment strategy(ies) for the superannuation fund is the responsibility of the trustee; however, under a member investment choice regime the selection of investments within a strategy is the responsibility of the member. Superannuation is a personal investment and therefore investment choice is the member's responsibility.[27]

4.32 Whatever the interpretation, evidence from the Law Council expanded on ABA's concerns, highlighting a number of inconsistencies with the advice contained in APRA's circular.[28] The Council suggested that APRA probably does not have a firm grasp of the law as it relates to the role of the trustee in a member investment

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25 IFSA, *Submission 60*, p. 21.

26 FPA, *Submission 38*, p. 10.

27 ABA, *Submission 88*, p. 15.

28 Law Council of Australia, *Submission 76*, pp. 4-6.

choice situation. It suggested further in evidence before the committee that the legal advice underpinning APRA's interpretation of the law should be made available and subject to review:

> It would seem to us that APRA has said…'Look, we've got legal advice. This is what it says.' I think the first good thing would be to have that legal advice subject to review then, from that, have a better dialogue with APRA, based on them having a firm understanding of what the law really is. It is probably just a bit of a genuine misunderstanding on their part as to what the law is in this case. I am not sure we need to go to a stage of direction from the government yet. But certainly this does need to be subject to review.[29]

4.33 A number of other submitters shared the concerns of the ABA and the Law Council, noting that APRA's interpretation of the SIS Act effectively undermines the member investment choice arrangements that many public offer superannuation funds provide for their members. The AXA submission, for example, provided a clear statement of the issue:

> One problem with the current regulatory environment is that the SIS Act explicitly recognises member investment choice, but APRA still expects the trustee to second guess a member's investment choices and to intervene in circumstances where the trustee does not believe the member's investment choice is prudent.
>
> …the tension between the trustee's obligations to protect the individual member's interests in relation to his/her investment selection and the member's right to select investments which he/she believes best suit his/her personal financial circumstances still exists.

The view of Treasury and APRA

4.34 Senior officials from Treasury told the committee that although Treasury was 'very comfortable' with APRA's revised circular and with the regulator's interpretation of policy, it was aware of tension in the superannuation sector created by an environment where members have choice of investment, and trustees have an obligation to ensure the prudential viability of the superannuation entity as a whole. Treasury drew two conclusions from this assessment. First, there is a constraint on member choice to the extent that the range of investment options offered to members by a fund is not unlimited. Member investment choice, in other words, is not unfettered choice. The trustee must only offer a suite of options that is appropriate for that fund in terms of the trustee's obligations under the SIS legislation. Members must then choose from that suite of options. Second, trustees cannot abrogate their responsibility under the SIS legislation to a financial planner on the basis that the financial planner knows the customer better. This is because:

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29 Mr Terry Brigden, Member, Superannuation Committee, Law Council of Australia, *Committee Hansard*, 7 March 2007, Sydney, p. 60.

> …the SI(S) Act requires [the trustee] to know the fund and the entity. It does not mean that the financial planner cannot be a very helpful source of advice to the individual member in choosing between funds and the like, but the trustee has an obligation that comes before that.[30]

4.35 However, when questioned further about conflict between a member receiving personal advice on how to invest money within a fund and trustee obligations under SIS, Treasury acknowledged the point but denied there was an 'inherent tension' in member investment choice arrangements:

> The trustees have to have an eye to their overall membership. The demographics of the membership of one fund may differ from another. There are a range of choices and they differ…The advice to someone may be that, while they cannot get what they need from this fund because of other people who are part of it and the basic structure and risk structure of that fund, they would be better off going to someone else because it suits their circumstances better. That seems entirely reasonable and it still ensures that the trustee is meeting their obligations to the fund as a whole.[31]

4.36 The evidence provided by APRA conveyed essentially the same message. The APRA submission reiterated the view that the SIS Act requires that the trustee must properly develop each investment strategy offered and provide the necessary information about them, in accordance with the SIS Act and regulations. Further, trustees cannot abrogate responsibility in relation to investment strategies by requiring members to seek their own financial advice.[32]

4.37 APRA's guidance states that there is no conflict between the trustees' obligation to determine how fund assets are invested on the one hand, and allowing a member to direct the trustee on specific investments on the other:

> The underlying policy intent is that the provision of member choice of investment strategy does not remove the need for the trustee to ensure that the investment strategy or strategies of the fund comply with the requirements set out in the legislation.[33]

4.38 At a hearing in Sydney on 7 March 2007, APRA provided a clear statement on the relationship between the role of the trustee in formulating investment strategies, the role of financial planning advice in a member investment choice situation and the constraints imposed on a trustee that in effect restrict the range of investment choices available to members:

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30 Mr Chris Legg, General Manager, Financial System Division, Treasury, *Committee Hansard*, Canberra, 20 November 2006, p. 10.

31 Mr Chris Legg, General Manager, Financial System Division, Treasury, *Committee Hansard*, Canberra, 20 November 2006, p. 10.

32 APRA, *Submission 51*, p. 7.

33 Australian Prudential Regulation Authority, *Superannuation Circular No. II.D.1: Managing Investments and Investment Choice*, March 2006, p. 4.

> Whilst the SI(S) Act does not prevent expressly a trustee from considering financial planning advice, a trustee must consider all the circumstances that an entity considers when formulating and implementing an investment strategy. Consequently, our approach has been to take the view that the extent to which a trustee takes financial planning advice would be incidental. We also note that the trustee does not have the ability to take into account the circumstances outside the fund itself.
>
> In summary we see the separate role of financial planner as providing advice to individual members about the allocation of the member's interests in the fund between the choices offered by the trustee and within the parameters set independently by the trustee.[34]

Is there a need for regulatory change?

4.39 The main message to emerge from the financial planning industry and peak superannuation associations is the need for regulatory change to clarify the operation of sections 52(4) and 52(2)(f) of the SIS Act. This would also require that further changes be made to APRA's circular on member investment choice. The submission from ASFA couched its main suggestion in very general terms: that the government consult with the superannuation sector to ensure a better integration between member investment choice and the current SIS obligations. Some concrete proposals from other organisations fleshed out the suggestion made by ASFA.

4.40 Two specific areas in need of change were identified. The first related to amending the SIS Act to clarify the duties of trustees of superannuation funds offering member investment choice. One proposal made by AXA is that section 52(4) of the SIS Act be modified: '…to make it clear that where an individual member provides a direction under this section the trustee does not have a responsibility to ensure that the selected investments are suitable to the individual member's financial circumstances and objectives'.[35] It argued that such an amendment would make it clear that the trustee's obligations do not extend to consideration of a member's financial circumstances.

4.41 Submissions from the FPA and Promina Financial Services recommended regulatory change to ensure that a trustee take into account any professional financial advice provided to members in respect of their superannuation. This follows from the concern that individual advice to a member from a financial planner need not be taken into account by the trustee.[36] The FPA argued that this situation not only has the capacity to limit the operation of government policy as embodied in Choice of Fund legislation, but also discourage members from taking an active interest in their financial future.

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34 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 93.

35 AXA Asia Pacific Holdings, *Submission 45*, p. 10.

36 FPA, *Submission 38*, p. 10; Promina Financial Services, *Submission 37*, p. 8.

4.42 The IFSA submission recommended that the SIS Act be amended to recognise the role of advice in superannuation and limit the duties of trustees to three distinct functions: formulating and documenting investment strategies, managing investments selected by members in a prudent manner, and reporting to members on those investments.[37]

4.43 The submission from Mercer Human Resource Consulting argued that APRA's approach is akin to a trustee being able to provide financial product advice to members without knowing the financial circumstances of members. It suggested that APRA's circular should be revised to recognise the reality that it is totally impractical for trustees to be aware of the total financial circumstances of members and any investment choice made by a member under member investment choice is ultimately the member's decision.[38]

4.44 The second area of change follows directly from the first and involves amending APRA's guidance to trustees. At the very minimum, it appears there is support within the industry for further discussion and review of APRA's approach as outlined in its circular.[39]

4.45 The Corporate Super Association submission proposed an amendment to section 52(2)(f) to address the potential for conflict between the need for trustees to maintain a responsible investment strategy and to provide investment choice. In circumstances where enough members specialise and invest in a narrow class of shares, the amendment would involve: '…specifying a sub-strategy within the overall strategy which relates to the narrow investment choice [of] members and which acknowledges that their liquidity and other requirements under s 52(2)(f) fall into a sub-class'. The Association argued that '…this is the only rational way in which the difficulties can, theoretically, be managed'.[40]

4.46 The committee notes that not all stakeholders expressed concern over the current regulatory framework relating to member investment choice. The Australian Institute of Superannuation Trustees (AIST) submission argued that the current framework, including APRA's guidance, is adequate, appropriate and practical for trustees to implement. The submission emphasised that in formulating an investment strategy, the trustee obtains professional advice from a number of sources, including its custodian, asset consultants, investment advisers, investment managers and other specialist in-house advisers, which is considered by the trustee at a board meeting.[41]

37 IFSA, *Submission 60*, p. 7.

38 Mercer Human Resource Consulting, *Submission 71*, pp. 12-13.

39 IFF, *Submission 73*, p. 22; REST Superannuation, *Submission 54*, p. 6.

40 Corporate Superannuation Association, *Submission 28*, p. 10.

41 Australian Institute of Superannuation Trustees, *Submission 79*, p. 22.

4.47 In a supplementary submission, IFF rejected the FPA's recommendation that a trustee be required to take into account any professional financial advice provided to members as misconceived and inconsistent with the responsibilities of a trustee:

> There is no basis on which a superannuation fund could take account of the individual situation of a member. Nor can it take account of any financial advice that member may have been given. A trustee has an obligation to manage the fund and its investment strategies for all members of the fund as a whole.
>
> A member is free to seek financial advice and is encouraged by most funds to do so, when selecting an investment option.[42]

4.48 The AIST submission also argued that while it is up to funds to offer a range of appropriate choices within which members may choose their individual investment options, a trustee is entitled to rely on a member's investment choice at face value: 'A Trustee should not be required to go behind that member instruction and consider whether it was appropriate or not for that member'.[43]

4.49 The view that investment choice does not provide members with an unlimited range of investment options to choose from was shared by the Recruiting and Consulting Services Association (RCSA) and Professional Associations Superannuation Limited (PASL) submission. It noted that although the common law and statutory duties of trustees may prevent some members from investing in the investment of their choice, there are alternatives:

> The fact that the trustee may not be able to provide all the investments that are available is not a major barrier to choice. Where a member wishes to invest their superannuation contributions in a discrete asset or volatile asset class that is not provided by any regulated fund, we believe that the member should be advised to pursue their investment preference through the use of a Self managed Fund (SMF).[44]

Committee view

4.50 The committee accepts that member investment choice and the responsibility of the trustee in this process have been handled well by the majority of trustees. The overwhelming majority of major funds have benefited from diversified investment options adopted in the medium term by fund managers.[45] Ultimately, the main safeguard is that each investment option is approved by the trustee. The only danger then is if the balance between options becomes a problem. However, there is no sign of this in the industry and it is unlikely to occur because the default option is likely to continue to prevail.

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42 IFF, *Submission 73a*, p. 7.

43 IFF, *Submission 73a*, p. 23.

44 RCSA and PASL, *Submission 56*, p. 9.

45 SuperRatings, *Submission 49*, p. 7.

4.51 The committee believes that the trustee's responsibility in a member investment choice situation should be to its core statutory duties, including to act in the best interests of all members, implement the fund's investment strategy in accordance with the SIS Act and ensure proper disclosure. However, the committee accepts that this issue has given rise to different interpretations over matters of law and policy. While any investment choice made by a member under member investment choice is ultimately the member's decision, the dividing line between the trustee's and member's responsibility may be legally unclear.

4.52 The committee accepts the widely held view that trustees should not be responsible for the investment choices made by individual members, as such. In other words, trustees should not be unilaterally interfering with member selections or supervising individual statements under investment choice. As long as the trustee's obligations under the SIS Act are met, individual members should be able to make their own investment decisions without any further intervention by the trustee. If trustees were to override investment decisions made by members as a result of receiving professional financial advice, a number of important questions would need to be answered: what training and resources would trustees need and at what additional cost to members? How would trustees communicate a decision to override investment choices to the member? What further licensing is required to regulate this quasi-personal advice role?

4.53 APRA's circular has been interpreted by some within the industry as imposing on trustees a duty to inquire into and monitor each member's investment choice. The committee believes that this is not the intent of APRA's directive and, anyway, would be both unworkable and inconsistent with the trustee's duty to act in the collective interest of members. The committee acknowledges that while APRA made a concerted effort to consult with industry over its revised circular, it has not been able to allay concerns within the industry over its interpretation of the law. The committee is concerned by the continuing level of confusion over differing interpretations of the trustee's responsibility in a member investment choice situation. There is a concern that APRA's interpretation may prevent trustees from offering real investment choice to those members who want it. This, however, has to be balanced by the sound view put to the committee by APRA and Treasury that member choice is not unlimited choice: trustees are not permitted to allow an individual member's investment choice if that choice would not be suitable for the fund as a whole.

4.54 The committee is sympathetic to the widely held view that APRA's guidance does not provide the clarity which is much sought after by the industry. APRA's written advice appears to have created uncertainty for some trustees and their advisers, not less. The main issue raised in evidence is that trustees cannot be expected to take into account the overall financial circumstances of individuals or whether they have received independent financial or investment advice. Some stakeholders are concerned that APRA's approach is inconsistent with the principle of investment choice and even with community expectations to be able to exercise freedom of investment choice.

4.55 The committee finds that the main problem with the interpretation of member investment choice lies deeper than APRA's guidance to trustees. The growing need for financial advice and its importance to the financial well-being of fund members, which has been recognised for some time by the government, has created major policy challenges for the industry, the parliament and for regulators. Some witnesses pointed to the fact that the SIS Act pre-dated the advent of the Choice of Fund initiative and member investment choice. This means the SIS legislation does not refer specifically to financial advice. When SIS was introduced the common approach was a 'one size fits all' investment strategy for all members who had little input into how their retirement savings should be invested. Generally speaking, the need for advice did not then exist to any degree because the investments made by funds tended to be simple, uncomplicated and fairly predictable.[46] (The complex relationship which has since developed between member investment choice and financial advice is examined in detail in Chapters 6 and 7.)

4.56 It appears that industry concerns with APRA's interpretation of member investment choice and the legal advice upon which it is based have arisen because of an underlying systemic problem – the legislation has not kept pace with industry developments, government policy or even community standards. The committee believes this is the root of the problem. The committee does not conclude that member investment choice is unsustainable in the current regulatory environment. The committee believes strongly that APRA and trustees can continue to work together on this issue within the confines of the SIS Act. The industry's acceptance of the philosophy underpinning member investment choice provides the solid policy platform on which differences of opinion can be resolved.

4.57 There is a strong case for APRA further clarifying the trustees' specific obligations under the SIS Act in order to better accommodate the existence of member investment choice.[47] This is why the committee urges APRA to make available its legal advice on the role of trustees in a member investment choice situation, as a starting point for further industry consultation over the wording of its superannuation circular.

Recommendation 9

4.58 The committee recommends that APRA make available for public scrutiny any legal advice it has received on the role of the trustee in a member investment choice situation, as a starting point for further industry consultation to clarify the duties of trustees of funds that offer member investment choice.

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46 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, 24 October 2006, Sydney, p. 94.

47 ASFA, *Submission 68*, p. 26.

Recommendation 10

4.59 The committee recommends that APRA, in consultation with the superannuation industry, review Superannuation Circular II.D.1 to clarify its interpretation of the role of the trustee in a member investment choice situation. The committee further recommends that APRA ensure that its written guidance better integrate the reality of investment choice and the obligations of trustees under the SIS Act.

Recommendation 11

4.60 The committee recommends that superannuation funds be permitted as part of reform to the disclosure regime to provide simple, standard advice to members at their request about the appropriateness or otherwise of non-standard default investment options within the fund.

Chapter 5

Capital requirements and other safety issues

5.1 A major theme in evidence during the inquiry was the importance of trustees addressing operational and governance risks before a fund experiences major difficulties that could threaten members' savings. The industry has placed a great deal of emphasis on prevention, which is a major premise of the current superannuation trustee licensing system. In addressing the issue of safeguarding superannuation savings, this chapter specifically addresses the following terms of reference:

- whether uniform capital requirements should apply to trustees (1);
- the relevance of Australian Prudential Regulation Authority (APRA) standards (3);
- whether funding arrangements for prudential regulation are adequate (10); and
- the level of compensation in the event of theft, fraud and employer insolvency (14).

5.2 Under the umbrella theme of safeguarding superannuation, this chapter also addresses two issues that are not formally part of the inquiry's terms of reference but were raised in evidence by a number of witnesses: identifying the owners of lost or unclaimed superannuation accounts and facilitating portability and the consolidation of multiple member accounts.

Capital requirements and unit pricing

5.3 Capital requirements have long been a feature of the prudential regulation of certain financial products, including for superannuation fund trustees that have a public offer entity licence under the SIS Act. Under section 29DA of the act, the capital requirements for licensees of registered superannuation entities (RSEs) can be met in a number of ways, including direct holding of the net tangible assets; approved guarantee; a combination for approved guarantee and net tangible assets; or meeting the custodian requirements. Trustees that hold an RSE licence of the non-public offer class are not subject to these, or any, specific capital conditions.

5.4 Section 29DA states specifically that to grant a licence, APRA must be satisfied that:

- the corporation's net tangible assets (NTA) is equal to or greater than the amount prescribed by regulations ($5 million);
- the corporation is entitled to an approved guarantee that is equal to or greater than the amount prescribed by regulations ($5 million);
- the corporation meets the requirements through a combination of net tangible assets and an approved guarantee ($5 million); or

- the corporation meets its requirements through custody of the fund's assets.

5.5 At the end of the RSE licensing period (30 June 2006), of the 121 applicants that had been granted a public offer or extended public offer licence, 41 met the capital requirements under the SIS Act with $5 million NTA, with a further 10 meeting the requirements by means of an approved guarantee of $5 million. The remainder met the capital requirements indirectly by having all assets held by custodial arrangement.[1]

5.6 According to advice issued by APRA, the capital requirements for the trustees of public offer funds have a threefold purpose:

- they provide some financial resources to act as a buffer against risk;
- they evidence a commitment on the part of the trustee to its superannuation business; and
- they act as an incentive to the trustee to manage the entity well.[2]

5.7 The issue of capital requirements for superannuation funds has been considered by the government on a number of occasions since the introduction of the SIS Act, most recently by the Superannuation Working Group (SWG) established in 2001 to inquire into options for improving the safety of superannuation. The issues paper released by the government gave three reasons for requiring all trustees to satisfy a capital requirement:

- to demonstrate financial substance and long-term commitment by the trustee;
- to have money at risk to provide an incentive to the trustee to manage the fund well; and
- to act as a ready buffer against operational or governance risk that may arise.

5.8 The SWG recommended that, as a part of the licensing process, APRA should determine the amount of resources, including capital, required to be held by each trustee to address the operational risks relevant to that trustee.[3] The government response supported, in principle, a risk-sensitive framework for the holding of capital to address operational risk. The government also indicated that it supported the retention of the status quo for capital requirements. This decision was, and continues to be, accepted by the industry as the appropriate response. The committee notes that

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1 APRA, *Submission 51*, p. 5.

2 Australian Prudential Regulation Authority, Superannuation guidance note SGN 150.1, *Capital requirements – net tangible assets*, July 2004, p. 5.

3 *Options for Improving the Safety of Superannuation*, Report of the Superannuation Working Group, Recommendation 16 'capital adequacy'.

the government's decision to maintain the status quo was based on the view that the need for capital in the future may be substantially reduced as other factors come into play to address operational risks.[4]

5.9 The committee notes that in its response to the SWG recommendations the government indicated that it would revisit the issue of capital requirements once the impact of the trustee licensing and risk management reforms could be assessed.[5]

5.10 The APRA submission noted that the licensing and risk management reforms introduced under the *Superannuation Safety Amendment Act 2004* included an operating standard that required all licensed trustees to have adequate resources, including adequate financial resources.[6] During the licensing period APRA assessed compliance with this operating standard by taking into account the nature, scale and complexity of each trustee's operations. According to APRA:

> …adequacy of financial resources was assessed on a risk basis tailored to each license applicant, rather than on a standard basis. In general, APRA maintained its previous practice of requiring public offer trustees that use the custodian option to meet the capital requirements of the SIS Act to have a minimum of $10,000 liquid assets available.[7]

Should uniform capital requirements apply to trustees?

5.11 Evidence before the committee demonstrated that the superannuation industry on the whole is opposed to the introduction of uniform or universal capital requirements. There is widespread agreement that any change to the existing rules on capital adequacy for trustees of superannuation funds is unnecessary and inappropriate and is unlikely to bring additional benefits to fund members. Evidence from a number of industry funds made the valid point that the introduction of the APRA licensing regime imposed a uniform and comprehensive system of risk management across all superannuation funds and required all funds to demonstrate the adequacy of their resources.[8]

5.12 Industry Funds Forum (IFF) argued that the SIS Act requirement to hold an RSE licence and the standards applicable to trustees prescribed under Part 3 adequately address the main areas of risk faced by trustees. These operating standards include the following categories:

- 'fit and proper' test to ensure superannuation funds are managed and overseen competently by honest and trustworthy individuals;

4 Investment and Financial Services Association, *Submission 60*, p. 9.

5 Treasury, *Submission 55*, p. 10.

6 APRA, *Submission 51*, p. 5.

7 APRA, *Submission 51*, p. 5.

8 See, for example, Industry Super Network, *Submission 77*, p. 5.

- risk management strategies to identify, monitor and manage risks concerning governance and decision-making processes; outsourcing arrangements changes in legislation applicable to an RSE licensee; and risks of potential fraud and theft;
- outsourcing arrangements from the terms of the contract through to monitoring, auditing and reporting obligations; and
- adequacy of resources to ensure that an RSE licensee has adequate resources to undertake its licensed activities.[9]

5.13 The Association of Superannuation Funds of Australia (ASFA) submission made the strongest case against uniform capital requirements by drawing attention to international experience and the negative effect uniform capital requirements would have on large sections of the superannuation industry:

> Extending identical and onerous capital requirements to all superannuation or pension funds is virtually without precedent anywhere in the OECD and fundamentally undermines superannuation provided as an employment benefit. This would primarily impact on the corporate fund sector, and to a lesser degree on industry funds. Any dramatic changes in this area could signal the death knell for such funds. In particular it would significantly push up compliance costs for those funds. Such a suggestion seems at odds with the Government's current concern over reducing the regulatory burden on business.[10]

5.14 SuperRatings also made the valid point that no amount of capital backing would be sufficient to protect members' assets in the event that a board of trustees without adequate safety procedures sought to wilfully defraud members, or sustained a significant loss through inadequate safeguards.[11]

5.15 The peak association representing self-managed superannuation funds did not support the extension of either uniform or minimum capital requirements to SMSFs. The Self-Managed Super Funds Professionals' Association of Australia (SPAA) submission argued:

> SPAA considers little would be achieved by requiring a trustee of a self-managed superannuation fund to satisfy minimum capital requirements. The provisions of the SIS Act applying to the operation of a self-managed fund include rules which ensure the safety of the member's balances and provide significant disincentives and penalties for any breaches of the legislation.[12]

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9 IFF, *Submission 73*, pp. 11-12.

10 ASFA, *Submission 68*, p. 7.

11 SuperRatings, *Submission 49*, p. 3.

12 SPAA, *Submission 70*, p. 5.

5.16 The Institute of Chartered Accountants in Australia suggested that APRA develop guidelines clarifying the method of determining the quantum of the reserve and the rules governing the operation of the reserves.[13]

5.17 The submission from MLC argued that consideration should be given to removing the custodial option for trustees on the grounds that custodial arrangements have the potential to compromise the ongoing viability of the fund and the investments to members. This is because a requirement for all fund assets to be held by the custodian: '…does not provide security or consumer protection for losses resulting from operational risk, trustee malfeasance or incompetence'.[14]

5.18 The Mercer Human Resource Consulting submission summarised a range of options to cover or partially cover the potential costs involved in adverse events that are totally outside the control of the trustee. However, it noted that not all of the cost mitigation options are available to all funds. Each fund would need to consider the most appropriate option when designing its risk management strategy. Of particular interest to the committee was the argument by Mercer that it would be inappropriate to concentrate on capital requirements as a potential remedy as it does not provide a total or practical solution:

> We consider that extending the capital requirements to all funds would result in:
>
> - The demise of corporate funds, and possibly some industry funds, with a consequent reduction in competition;
> - SMSFs becoming non-viable with a further reduction in competition.[15]

5.19 A lone voice in support of uniform capital requirements was provided in evidence by the Association of Financial Advisers (AFA). The submission stated without qualification that association members hold the view that trustees of all commercial funds should be required to have the same capital adequacy requirements of their trustees:

> …all providers of superannuation funds that are classed as public offer funds should be required to have the same standards of capital adequacy…The need to have funds [to] provide capital reserves for the management of operational risk should be paramount.
>
> No discrimination is to be allowed as this may cause a future failure and thus undermine public confidence in the regulator and the whole program of retirement savings.[16]

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13 Institute of Chartered Accountants, *Submission 43*, p. 2.

14 MLC, *Submission 83*, p. 4.

15 Mercer Human Resource Consulting, *Submission 71*, p. 5.

16 AFA, *Submission 62*, p. 3.

Unit pricing

5.20 Evidence from MLC drew the committee's attention to unit pricing as a significant function undertaken by most retail and commercial superannuation funds and the role that capital can have in the event that unit pricing errors occur. Within the financial services industry a collective investment is often 'unitised'. In the case of superannuation funds, this means that a member's holdings are expressed in the number of units held in the fund and the cumulative value of those units. Unit pricing essentially refers to the method of fund valuation which, according to MLC:

> …is used for the equitable apportionment of investment earnings or losses in accumulation funds. It is used to calculate the unit price for members entering the fund and members realising their investment at the point of exit.[17]

5.21 MLC told the committee of a 2001 unit pricing error involving several national wealth management companies that remained undetected for a number of years.[18] Apparently, the companies made unit price reductions which, in association with other unit pricing errors, adversely affected a large number of investors. The companies entered into an enforceable undertaking with ASIC and APRA and put in place comprehensive investor compensation and remedial action programs.[19] MLC told the committee: 'It was a small error that affected a large number of accounts, which was quite a big problem in the end—over $70 million, which was made good back to the investors from the shareholders'.

5.22 MLC argued that the $5 million minimum capital adequacy pales into insignificance in the context of a unit pricing error of this magnitude: 'With respect to the $5 million figure, quite frankly, if you end up with a unit pricing error of the magnitude of ours, it is not going to get you anywhere'.[20] Mr Tucker told the committee of a reported $750 million of unit pricing errors in the superannuation industry over the last few years, all of which have occurred in retail funds with the capital backing of institutions.[21]

Committee view

5.23 The committee accepts that trustee licensing requires trustees to have prudential risk management strategies and risk management policies on 'fit and proper' persons, outsourcing and adequacy of resources. Trustees are also required to develop

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17 MLC, *Submission 83*, p. 6.

18 MLC Nominees, National Australia Financial Management and National Australia Superannuation Pty Ltd

19 MLC, *Submission 83*, p. 8.

20 Mr Steve Tucker, Chief Executive Officer, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 76.

21 Mr Steve Tucker, Chief Executive Officer, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 75.

and maintain detailed risk management documentation. The committee notes further that the policies and risk compliance frameworks adopted by trustees are subject to auditing and regular review by APRA.

5.24 The committee accepts the widely held view in the industry that capital requirements can be a crude mechanism for preventing operational and governance risks. While it is important that all funds adopt a strong risk management process and strategy, the committee recognises that there are various ways for funds to manage risk and mitigate the potential costs from any adverse events that may occur. The committee is of the view that a number of regulatory developments over recent years have made uniform capital requirements unnecessary, at least in the short term. In particular, the introduction of a universal licensing regime has significantly raised the barrier to entry for trustee entities.

5.25 The policies and procedures adhered to by trustees have provided APRA with information to identify and mitigate operational and governance risks that is more precise and timely than the existence of capital. This view also appears to be consistent with international debates concerning the role of capital in financial services regulation. As already noted by ASFA and others, any attempt to impose a 'one size fits all' capital requirement on superannuation funds is inconsistent with choice and competition as it may result in a further rationalisation of superannuation funds. In relation to the last point, the committee notes in particular the concerns expressed by industry funds and corporate funds. It accepts the view that it would be very difficult for employer organisations and unions to satisfy anything other than a nominal capital requirement.

Recommendation 12

5.26 The committee recommends that superannuation funds improve the disclosure of their capital backing and/or the risk protection of capital and that APRA assist the industry with the development of disclosure of risk management systems to protect superannuation investors' funds.

5.27 The committee is concerned by the magnitude of unit pricing errors involving retail funds with the capital backing of institutions, which has reached a total of $750 million. As the MLC experience has demonstrated, unit pricing errors can remain undetected for a number of years and have significant adverse consequences for large number of investors. However, the committee notes that according to APRA the number and size of new unit pricing errors had declined considerably over the past 12 months, and those that did occur were corrected at no cost to investors.[22] According to APRA, since the release of the joint ASIC/APRA good practice guide on unit pricing in November 2005 there has been a reduction in the frequency and size of unit pricing errors.[23]

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22 Greg Bright, 'APRA "warns" funds on capital adequacy after unit pricing errors hit $750m'.

23 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 94.

5.28 The committee notes that the accuracy and method of fund asset valuation is critical to the integrity of the investment process and ultimately investor confidence. Submissions from MLC and IFSA made a strong case for a mandatory unit pricing methodology.[24] Fund choice and portability rules have contributed to inter-fund membership flows, which increases the need for funds to accurately price members' savings. According to IFSA:

> [unit pricing] is the most equitable structure as an investor gets credited with the actual investment amount earned on their assets. It also gives the investor certainty as to what their account balance is at any point in time.[25]

5.29 Chief Executive Officer of MLC, Mr Steve Tucker, also told the committee that unit pricing is the best model to ensure that equity and fairness remain features of the superannuation system. Therefore, all public offer superannuation funds should operate under a daily unit pricing structure:

> We think that unit pricing – and it is quite clearly agreed with by APRA and ASIC in their best practice guides – is the best way to ensure equity amongst members coming and going from funds. The move to a unit pricing system allows people to come in and leave at the right price every day. It is a fair, if not slightly complex, way of making sure that there is equity amongst members.[26]

5.30 APRA told the committee there is currently an industry-wide trend towards unit pricing.[27]

5.31 The joint ASIC and APRA good practice guide on unit pricing made the following positive comments on the benefits of unit pricing:

> …unitisation provides a more direct link to movements in asset values, investment income and transaction costs, as unit process are calculated at, or closer to, the time unit holders acquire or dispose of products. Unit pricing avoids transferring investment returns between entering, leaving and ongoing unit holders (generations of unit holders). That is, unitisation may be perceived as providing more transparency and resulting in more equitable treatment of beneficiaries and fund members…[28]

5.32 The committee agrees that unit pricing is the most appropriate way to allocate investment earnings and appears to be the best way to ensure equity for members who move between funds. Unit pricing should be mandatory, at least for all public offer superannuation funds.

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24 MLC, *Submission 83*, pp. 5-7; IFSA, *Submission 60*, pp. 39-40.

25 IFSA, *Submission 60*, p. 39.

26 Mr Steve Tucker, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 74.

27 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 94.

28 *Unit pricing: Guide to good practice*, Joint ASIC and APRA guide, November 2005, p. 18.

Recommendation 13

5.33 The committee recommends that the government mandate a uniform unit pricing methodology for all public offer superannuation funds, including any transitional arrangements. The committee also recommends that where unit pricing is utilised improved operational risk parameters are identified and implemented by APRA.

APRA standards

5.34 APRA does not have the power to make prudential standards in relation to the superannuation industry. The government previously rejected a recommendation by the Superannuation Working Group that APRA be given this power. The government considered that APRA could achieve all its objectives within the existing regulatory framework once the trustee licensing regime was implemented.[29] The APRA submission stated that its guidance is 'non-binding'. Its aim is to:

> …assist trustees of APRA-regulated superannuation entities to comply with legislative requirements and, more generally, to encourage prudential good practices in relation to specific issues. APRA has an active program to ensure that this material is updated to reflect changed requirements flowing from amended legislation and/or to provide further guidance in response to industry developments.[30]

5.35 As previously noted, SIS regulations included several operating standards that establish minimum standards in relation to key aspects of a trustee's operations. The operating standards are generally regarded in the industry as appropriate and necessary for the proper and prudential management of superannuation funds. Thus there was widespread agreement with the Australian Institute of Superannuation Trustees' view that the standards provide a strong framework for the protection of members' superannuation:

> The range of Operating Standards set the framework within which a superannuation fund trustee must operate its business and to set appropriate parameters and guidelines on such matters as how members can contribute to superannuation, gain access to superannuation, the payment and preservation of benefits and other operational matters of superannuation funds, including investments, solvency of Trustees, and the winding up of superannuation funds.[31]

5.36 In addition to the operating standards, APRA provides general guidance to superannuation funds on how it interprets and administers relevant legislation. This guidance is provided in the form of superannuation circulars, frequently asked

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29 Mr Steve Tucker, Chief Executive Officer, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 74.

30 APRA, *Submission 51*, p. 7.

31 Australian Institute of Superannuation Trustees, *Submission 79*, p. 13.

questions, superannuation guidance notes and other information for RSE licensees. The Treasury submission noted that the government's Regulation Taskforce recommended that APRA review its guidance material '…to ensure it provides effective guidance on good practice in meeting regulatory requirements and does not impose additional or inflexible regulatory requirements'.[32] The government has referred this recommendation to APRA for its consideration.

Criticism of APRA's guidance

5.37 APRA's standards and circulars are generally regarded in the superannuation industry as providing useful guidance in clarifying APRA's interpretation of the law and how they will regulate it. As noted in the previous chapter, there are major concerns in the industry over APRA's legal interpretation of the role of trustees in a member investment choice situation, as contained in Superannuation Circular II.D.1. Criticism of APRA's guidance, however, extends beyond the specifics of member investment choice.

5.38 A number of organisations expressed concern about how APRA's guidance is used in practice, the lack of consultation with industry and the apparent lack of coordination and consistent interpretation between the regulators (on the issue of regulatory overlap see the discussion in Chapter 3). The Law Council of Australia submission argued that, in the experience of its members, the SIS Act is worded in such a way as to give APRA a de-facto standard making power that amounts to imposing new legislative requirements. Specifically:

> We endorse the principle of APRA assisting trustees in managing prudential risk but believe that APRA's powers have been, in effect, inappropriately extended through the standard-making power so that APRA can achieve through non-legislative means results which are not expressly allowed or intended by the SIS Act or by announced Government policy.[33]

5.39 SuperPartners agreed arguing that APRA's superannuation guidance notes go further than the scope of the regulations they purport to interpret:

> For instance, the APRA Outsourcing Standard states an outsourcing agreement should provide that breach of confidentiality may result in penalties or termination of the agreement, in contrast with the Regulations which state that the agreement must provide for confidentiality.[34]

5.40 SuperPartners expressed concern that the prescriptive detail of APRA's standards disguises the fact that they operate as de facto regulations and, therefore, as preconditions to obtaining an APRA licence. As previously noted, while APRA stated that its guidance material has no legal status or legal effect, sections of the industry believe that compliance with APRA's guidance is expected for a licence application to

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32 Treasury, *Submission 55*, p. 12.

33 Law Council of Australia, *Submission 76*, p. 3.

34 SuperPartners, *Submission 67*, p. 9.

succeed. The Investment and Financial Services Association (IFSA) submission noted that APRA's guidance notes and circulars are effectively administered as law, but without parliamentary scrutiny.[35]

5.41 The Law Council of Australia agreed, noting that anecdotal evidence suggests that some funds have viewed the prospect of their licence being withheld or revoked unless they accept APRA's guidance, as an 'implied threat':

> Quite often what happens is that once you have your licence and you are up and running, there are times where funds may very well take a view that they do not agree with the approach being taken by APRA, but nonetheless they do not believe that they can use members' money to contest that view, so quite often they acquiesce and go along. While this is not intended to be a criticism of APRA…it is just that in certain areas I think that they need to have greater dialogue with the industry prior to actually producing and introducing guidelines and about how they actually apply them.[36]

5.42 On the issue of dialogue between APRA and the industry, the IFSA submission noted that the law does not require any meaningful consultation to occur and, even where it does, there is no effective mechanism to ensure that industry concerns are properly considered by APRA. This is why IFSA recommended a more effective consultative process to be spearheaded by a new advisory body, the Financial Services Committee. IFSA also recommended that there should be greater emphasis and reliance on the development of industry codes of practice and self-enforcement and on the analysis of the costs and benefits of regulatory proposals.[37]

5.43 There is some industry support for there to be statutory recognition of APRA standards, most likely in the form of operating standards under existing powers. SuperPartners argued that this has become necessary in order to control APRA's powers and to achieve consistency with subordinate legislation.

Funding prudential regulation

5.44 Unlike insurers or approved deposit taking institutions that are governed by regulators funded out of consolidated revenue, superannuation trustees (as well as other financial sector organisations) pay for their own regulation via a levy provided for under the *Superannuation Supervisory Levy Imposition Act 1998*. The levy is set with the aim of covering the operational costs of APRA and certain market integrity and consumer protection functions undertaken by ASIC and the ATO. The remainder of APRA's costs are recouped through direct fees and charges. The levy is determined by the Minister for Revenue and Assistant Treasurer after consultation with various representative industry bodies.

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35 IFSA, *Submission 60*, p. 10.

36 Mr Terry Brigden, Member, Superannuation Committee, Law Council of Australia, *Committee Hansard*, 7 March 2007, Sydney, p. 55.

37 IFSA, *Submission 60*, pp. 10-11.

5.45 According to Treasury, there are a number of methods for recovering the costs of prudential supervision from industry. These range from individualised fee-for-service arrangements to broad based funding from the financial sector as a whole, ignoring the individual costs of regulating particular industry sectors or institutions. Apparently, the last review of levies found problems with both these models and industry did not support them.[38] It is widely recognised that the current levy arrangements have their genesis in recommendations of the Wallis Inquiry, which proposed that charges be made by the regulators for services directly provided and general expenses be recovered by way of a levy on relevant financial institutions.[39]

5.46 Levies for different industry sectors are based on the total value of the assets of regulated institutions. According to Treasury:

> Total assets are considered to be correlated with the level and cost of prudential supervision by the regulator, an institution's capacity to pay, the impact on the system of its possible failure and the institution's stake in a stable financial system.[40]

5.47 The current financial sector levy rates were released by the Assistant Treasurer and Minister for Revenue in July 2006 after a process of industry consultation on a paper entitled 'Proposed Financial Sector Levies for 2006-07'. It was noted at the time that due to the significant structural changes experienced by the superannuation industry, the transitional levy arrangements that applied to superannuation entities in 2005-06 would be extended in 2006-07.[41] The committee notes that Treasury and APRA are currently examining the long term effect of the decline in the number of superannuation funds on prudential regulation and financial sector levies, with a view to consulting with industry on these issues.

5.48 The estimated funding for superannuation supervision for 2006-07 is $46.2 million, comprising $34.2 million for APRA funding, $8.2 million in costs relating to work undertaken by ASIC and $3.8 million in costs relating to work undertaken by the ATO. This amount represents 43.9 per cent of the total levy.[42] APRA told the committee at a hearing that its share of the levy in terms of ongoing supervision costs is less that three cents per week per member account compared to administration costs incurred by the superannuation industry in 2006 of $1.85 per week per member account.[43]

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38 Treasury, *Submission 55*, p. 21.

39 ASFA, Submission 68, p. 36.

40 Treasury, *Submission 51*, p. 22.

41 Treasury, *Submission 51*, p. 10.

42 Australian Institute of Superannuation Trustees, *Submission 79*, p. 34.

43 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 7 March 2007, Sydney, pp. 93, 103.

Are current funding arrangements equitable?

5.49 An important issue that came to light during the inquiry is that following the introduction of RSE licensing the number of superannuation trustees to fund the levy has reduced considerably. This has given rise to different views among industry players as to the equity or otherwise of the current funding arrangements. Some existing funds believe they are bearing a larger proportion of the costs of prudential regulation. REST superannuation, for example, argued in its submission that the average account of its members is approximately $6000, which means the fund is bearing a greater financial burden than before.[44] Hence there is some support in the industry for a more equitable distribution of regulatory costs based on the size of individual funds.

5.50 REST Superannuation told the committee the fund paid APRA in excess of $300,000 in 2005 for the purpose of prudential regulation. It argued that:

> …there is potentially a better way that is partly asset test because assets are some surrogate for risk. But there should also be a specific levy or assessment of risk so that there is incentive for trustees to be governed appropriately. So instead of larger funds subsidising the cost of supervision of smaller funds, there is a failure to differentiate between high-risk and low-risk funds. With the introduction of RSE licensing, the number of trustees available to fund the levy has vastly reduced. This means that a small number of existing funds are bearing a larger proportion of the costs.[45]

5.51 Others in the industry agreed by highlighting the inequity in funding arrangements that work against the interests of the larger funds. The submission from Industry Funds Forum argued for a fundamental rethink of funding arrangements to remove cross subsidies from the calculation of the levy in which larger funds subsidise the cost of regulating smaller funds. This would be achieved by shifting the focus of how the levy is calculated from the size of a fund to an assessment based on risk and compliance, a move that appears consistent with the evidence from REST. Calculating the levy based partially on an assessment of risk was also supported in evidence by Equipsuper, IFSA and the Corporate Superannuation Association.[46] According to Industry Funds Forum:

> Funds that do comply and can demonstrate an ongoing commitment to compliance should be rewarded rather than penalised for their efforts. IFF recommends that the Government consider a more innovative approach, which not only facilitates supervision but also promotes compliance. For example a reduction of the levy for funds which meet appropriate

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44 REST Superannuation, *Submission 54*, p. 8.

45 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, 24 October 2006, Sydney, p. 58.

46 Equipsuper, *Submission 30*, p. 16; IFSA, *Submission 60*, p. 29; Corporate Superannuation Association, *Submission 28*, p. 11.

> compliance obligations, can demonstrate a compliance culture and effective controls. Those that fail to measure up conversely would incur a higher levy based on a level of risk that their non-compliance creates[47]

5.52 Mercer Human Resource Consulting made a similar case by highlighting the significant costs involved in regulating the industry, especially for large superannuation funds. It argued that the annual levy can exceed $150,000 which can significantly exceed the cost of directly monitoring that particular fund. A high levy will result in either higher fees or lower investment returns for fund members.[48] The Mercer submission recommended that the cost of regulation should be largely borne from consolidated revenue.

5.53 Others in the industry argued in favour of the status quo on the grounds that the current framework is equitable and ensures accountability, efficiency and transparency. The Australian Institute of Superannuation Trustees argued that basing the current funding framework on the assets of a superannuation fund is fair because larger funds should pay more than small funds. It argued further that:

> The levy, as it stands, arguably encourages superannuation fund Trustees to perform better, as they know that any increase in regulator activity will need to be funded, and as the levy is paid directly by the Trustees, there is some incentive to perform in accordance with the Regulator's expectations…[49]

Committee view

5.54 The committee has some sympathy for the view that the levy should reflect the actual costs incurred in supervising superannuation entities regardless of asset size. However, the committee accepts the counter-argument that it would be impractical for the levy to be set in accordance with the amount of time APRA spent regulating particular funds. Nor does the committee support using the risk profile of funds as a criterion for setting the levy. While the committee accepts there is some cross subsidisation by the larger funds trustees, it believes that the current method of funding arrangements for prudential regulation ensure transparency, relative equity and ease of administration by APRA. The committee therefore does not believe that another review of the levy issue is warranted at this point in time. Overall, the committee accepts there must be accountability to ensure that revenue collected from superannuation funds to pay for the regulation of the industry is matched as closely as possible to the actual cost of supervision.

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47 Industry Funds Forum, *Submission 73*, p. 39.

48 Mercer Human Resource Consulting, *Submission 71*, p. 23.

49 Australian Institute of Superannuation Trustees, *Submission 79*, p. 35.

Compensation arrangements

Theft and fraud

5.55 Under current arrangements, Part 23 of the SIS Act enables the trustee of a superannuation fund to apply to the Minister for a grant of financial assistance where the fund has suffered loss as a result of fraudulent conduct or theft that leads to 'substantial diminution of the fund leading to difficulties in the payment of benefits'. The minister has discretion to compensate up to 100 per cent of a loss suffered due to fraudulent conduct or theft. According to Treasury, it has been long-standing government policy to cap financial assistance at 90 per cent of the eligible loss. It argued that the capping of financial assistance is consistent with international best practice, has the support of industry, reduces the risk of moral hazards and promotes an equitable outcome between members suffering losses:

> The 90 per cent cap is intended to assist in ameliorating the risks of moral hazard by providing incentives for superannuation fund members to ensure that their fund is being managed in a prudent manner. The Government considers that the provision of financial assistance for the full eligible loss would not reflect that fact that members bear the full risks of their superannuation investments and would undermine the financial incentives for superannuation fund managers to monitor and take an active interest in the management of their retirement savings.
>
> The capping of financial assistance for eligible losses is consistent with international best practice and with other major Government assistance programmes in Australia. Financial assistance schemes overseas generally limit the compensation paid through either a percentage or a monetary cap.[50]

5.56 The cost of providing financial assistance under Part 23 of SIS is recouped through an industry levy imposed on all superannuation funds eligible for financial assistance.

5.57 APRA plays a key role in the provision of compensation under Part 23. Its main role is to provide advice to the minister in relation to an application for assistance, and to administer the *Superannuation (Financial Assistance Funding) Levy Act 1993* and the Superannuation (Financial Assistance Funding) Levy and Collection Regulations 2005. The submission from APRA noted that as of September 2006 it had administered three separate collections for the recovery of amounts paid out as financial assistance under Part 23: 'A total of $44.7 million in compensation payments has been recovered from industry over three financial years (2001-2002 to 2002-2004)'.[51]

50 Treasury, *Submission 55*, p. 25.

51 APRA, *Submission 51*, p. 13.

5.58 In considering the current arrangements for compensation several important questions arise: what circumstances should be covered by a compensation scheme? Who should fund a superannuation compensation system? And, what level of compensation should apply? The submission from Trowbridge Deloitte argued that coverage by the Superannuation Protection Account should include negligence, catastrophic claims or investment performance. It also suggested that the cover could be extended by defining or interpreting 'substantial diminution' to mean any catastrophic losses that exceeded a particular percentage of the fund's assets. However, it noted that such extended coverage could become particularly expensive to administer and subject to moral hazards: '…all stakeholders might become more lax knowing that they would be compensated. The costs would be likely to fall on well managed funds'.[52]

5.59 There is some concern in the industry that the current levy arrangements discriminate against members in funds that have to meet the cost of any compensation. It is for this reason that some organisations recommended that the financing of compensation should be met from consolidated revenue rather than by other better managed funds. Mercer, for example, stated that

> With the reduction in the number of funds, a failure in one large fund could result in a very significant level of compensation being funded by members of other funds. This itself could lead to a loss of confidence where members of funds that have performed well are potentially significantly reduced.[53]

5.60 There does not appear to be much support in the industry for either establishing new levies as a tool for compensation in the event of theft and fraud, or introducing any broader compensation arrangements for institutional failure. Industry Funds Forum argued that compensation levies are inappropriate and by their very nature regressive because they have the greatest effect on the members who have small account balances and are therefore least able to afford it.[54] The IFSA submission made a strong case against the introduction of any explicit industry funded guarantee scheme. It argued that schemes of this nature result in increased costs to consumer; reduce standards by underwriting inefficiency and complacency; increase the risk of failure; result in more claims on a fund because customers have less incentive to be risk averse; and diminish trust in the industry.[55]

5.61 The ASFA submission advocated replacement of the 90 per cent compensation cap with a sliding scale based on the losses of individual members within a fund. It suggested that under such a scheme compensation would be paid as follows:

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52 Trowbridge Deloitte, *Submission 80*, p. 9.

53 Mercer Human Resource Consulting, *Submission 71*, p. 30.

54 Industry Funds Forum, *Submission 73*, p. 45.

55 IFSA, *Submission 60*, p. 36.

- 100 per cent compensation for losses incurred on amounts up to an individual member's tax-free threshold;
- 80-90 per cent compensation for losses incurred on amounts between an individual member's tax-free threshold and an individual member's pension Reasonable Benefit Limit (RBL); and
- no compensation paid for losses incurred on amounts above an individual member's pension RBL.[56]

Employer insolvency

5.62 There is currently no mechanism to enable a fund to notify its members in the event that an employer fails to pay its superannuation liabilities due to the state of their business, including in the event of employer insolvency.[57] A fund is only able to legally pursue any unpaid superannuation contributions where there is a written agreement between the trustee and the employer sponsor requiring the payment of contributions and specifying when such contributions should be made.[58]

5.63 SuperRatings argued that members should be better educated to regularly monitor their employer's quarterly contributions. The research firm further argued that in the event of employer insolvency: '…employee superannuation contributions should rank ahead of all creditors as they are effectively part of an employee's income which should have already been earned and paid'.[59]

5.64 There is also some support within the industry to mandate that employer contributions be paid monthly and not quarterly.[60] According to the Australian Council of Trade Unions (ACTU), the requirement for Superannuation Guarantee contributions to be paid into a fund every quarter is an improvement:

> …the reality is that when an employer becomes insolvent the likelihood is that employees' superannuation contributions will be in arrears, together with members' own voluntary contributions and/or any additional amounts payable through salary sacrifice.[61]

5.65 AIST told the committee that monthly payments will help guard against employer insolvency and the loss of members' retirement benefits:

> Implementing a legislative provision to require employers to pay their SG contributions monthly will help prevent the loss of members' retirement

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56 ASFA, *Submission 68*, p. 44.

57 SuperRatings, *Submission 49*, p. 11.

58 Industry Funds Forum, *Submission 73*, p. 46.

59 SuperRatings, *Submission 49*, p. 11.

60 Employers are required to pay their Superannuation Guarantee (SG) contributions on behalf of employees with 28 days of the end of the quarter in which the SG contributions are due.

61 ACTU, *Submission 72*, p. 17.

> benefits and guard against the risk of employees losing their superannuation entitlements due to employer insolvency.[62]

5.66 The Australian Chamber of Commerce and Industry (ACCI) submission noted that better data is needed on the extent to which an employer's superannuation obligations are not met as a result of insolvency. While it suggested that some of this data may be available through the operation of the General Employee Entitlements and Redundancy Scheme (GEERS), ACCI does not support any extension of GEERS to cover unpaid superannuation contributions.[63]

5.67 This view was not supported by submissions from Mercer, the ACTU and ASFA, which argued that GEERS should be broadened to cover unpaid superannuation contributions, not only because superannuation contributions are compulsory, but also because they form a basic part of employees' overall remuneration.[64] The ASFA submission also supported granting additional powers to the ATO to pursue outstanding SG payments for employees and former employees, and placing restrictions on the Deeds of Company Arrangement being used to reduce employee superannuation entitlements.[65]

Committee view

5.68 The committee accepts that it is impossible for the superannuation industry, which has now surpassed $1 trillion in savings, to completely insulate itself against the fraudulent activities of unscrupulous operators. The Managing Director of SuperRatings conveyed this message directly to the committee when he said the superannuation industry is going to attract fraud and malpractice because of the volume of assets under management: 'People will get ripped off, no matter what regulations you have in place'.[66] This is why member protection on the whole is reliant on diligent trustees, effective prudential regulation and workable compensation mechanisms. While the extent of losses stemming from illegal behaviour is reported to have been as low as 1 per cent over a 13 year period, compensation in the event of fraud or theft is widely regarded as critical component of a compulsory savings system which, in turn, is an important part of the national economy. As the submission from Mercer noted:

> If there was no compensation in the event of a major superannuation fund fraud, then there could be a major loss of community confidence. This

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62 Australian Institute of Superannuation Trustees, *Submission 79*, p. 43.

63 ACCI, *Submission 66*, p. 8.

64 Mercer Human Resource Consulting, *Submission 71*, p. 31; ACTU, *Submission 72*, p. 18.

65 ASFA, *Submission 68*, p. 43.

66 Mr Jeff Bresnaham, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 14.

> would be undesirable from the point of view of the Government, members, employers and the general community.[67]

5.69 The committee accepts the view that the compulsory nature of superannuation demands a high degree of community confidence in the integrity of the system. Confidence is guaranteed in part by the existence of robust mechanisms to deal with instances of theft and fraud. This is why the committee believes that the existing compensation arrangements under Part 25 of SIS for theft and fraud are an appropriate regulatory response to criminal activity of this nature. The committee is comfortable with the current levy arrangements, the amount of which is determined after an event involving theft or fraud has occurred. The committee believes that the amount of any so-called 'pre-event' levy would be difficult to determine and could potentially impose an unacceptably high cost on the industry.

Recommendation 14

5.70 The committee recommends that the government examine whether employee salary sacrifice should be paid by the employer at a minimum at the same time as the compulsory SG, and whether employer SG contributions should be paid on the pre-salary sacrifice income.

5.71 The committee notes the arguments for monthly rather than quarterly payments to help guard against the loss of employee entitlements in the event of employer insolvency, and for GEERS to be extended to cover superannuation entitlements. However, the committee believes it is premature to make any recommendations that address these specific concerns. The committee has previously formed the view that better data on the extent to which employers are unable to meet their superannuation obligations as a result of insolvency is needed, including in circumstances where there were insufficient company records. In its March 2007 report on draft insolvency laws, the committee voiced concern that some employers who are entitled to recover money under GEERS, including superannuation entitlements, are unable to do so because the company did not keep any paperwork. The committee supported practical and cost-effective measures to improve record keeping and the level of information that is provided to administrators. It also recommended that the government compile data on the incidence of employees who are unable to receive their entitlements under GEERS due to a lack of company records. The committee has not changed its view on these matters.[68]

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67 Mercer Human Resource Consulting, *Submission 71*, p. 30.

68 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment (Insolvency) Bill 2007 [Exposure Draft]*, Report, March 2007, p. 20.

Portability and exit fees

Portability

5.72 Over recent years, the portability and choice of superannuation fund for investors has been extended. Portability of superannuation refers to the ability of superannuation fund members to roll over and transfer existing superannuation benefits from one regulated superannuation fund, approved deposit fund or retirement savings account to another, whereas choice of superannuation fund refers to the ability of employees to choose the fund to which their employer directs future superannuation guarantee contributions.

5.73 The committee notes that the government has introduced further measures to simplify the transfer of superannuation benefits between funds and improve arrangements in respect of lost and unclaimed superannuation.[69] Two initiatives will make it easier for individuals to transfer superannuation benefits between funds and take more control of their superannuation, and reduce processing delays.

5.74 Funds are required to use a new standardised form for portability to facilitate the transfer of benefits between funds. This includes standard proof of identity requirements to ensure uniformity between funds. The maximum time period in which this transfer must occur has been reduced from 90 days to 30 days. The 30 day period commences after a person has provided all necessary information. Trustees are required to follow up incomplete requests for transfers promptly. These new arrangements came into operation on 1 July 2007.

5.75 Notwithstanding these new measures, the committee heard evidence in relation to a number of shortcomings with the consolidation process. Much of the discussion on portability during the committee's hearings focused on the ease and speed of the process as it occurs between funds. The difficulty for investors of obtaining good and affordable advice about consolidating funds was a particular concern of witnesses. Mercer Human Resource Consulting submitted that:

> [W]hen somebody has three or four funds, and says, ‘I want to bring them all together; which fund should I go to?’ a piece of advice is needed there. I think that advice is not currently being given because it is too hard to get, too expensive, and the financial planners are not interested.
>
> …
>
> It is like, what does insurance mean? Does this fund offer insurance? It is a more contained piece of advice, and the appropriate disclosure is, ‘I am not doing a full financial statement of advice to you; instead your scope of job was, “Which fund of these three should I merge into?” I have looked at

69 Tax Laws Amendment (Simplified Superannuation) Bill 2006 and related bills.

> these three funds, which has taken me an hour, because they are all on my database; I will charge you $50 for it, or $100, but not $700.'[70]

5.76 The committee expressed particular interest in the ease and speed with which accounts are able to be consolidated. It was submitted that some funds were not releasing funds as quickly as they were able to, as a result of administrative formalities imposed by the fund or deliberate stalling. In many cases, fund members gave up trying to get proceeds released altogether. During a hearing, a committee member commented:

> The lesson is that employee relationships and the ability to get information out of them is limited. I am saying to you as corporates, you want to hang on to other people's money, and it is not helping them move it. They know that if they put enough impediments, people will just give up and the money stays. This is a classic corporate activity. It happens all over the world. Companies develop systems to ensure that they get a bit of cash flow through paying people late or whatever. It is well known in the business world. I am saying that it is happening in portability with respect to forms and the way in which people operate.[71]

5.77 No witnesses reported having direct knowledge of these practices, although it was acknowledged that verification procedures could be time consuming.[72] Rainmaker Information commented that part of the reason funds may take time in releasing funds was the lack of clear regulatory guidance about the procedures to be followed when doing so:

> What we also need is regulation that facilitates it, because one of the things the trustees will say is that, 'Well, the rules say that as the trustee we have got to make sure we do the right thing,' and some trustees genuinely believe that if someone rings up and says, 'I'm with low-cost fund X and I want to move my money to master trust Y,' they go, 'Hang on. That doesn't sound right. I've got to make sure that Alex is trying to do the right thing here.' So they go into this process of, 'How do we know Alex is making the right decision?'[73]

5.78 Choice summarised a research paper that investigated the high cost to consumers of multiple accounts.[74] It submitted that consumers were insufficiently aware of the higher costs involved in maintaining multiple accounts. However, the barriers to consolidation did not stop there:

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70 Mr David Knox, Principal, *Committee* Hansard, 25 October 2006, Melbourne, p. 77.

71 Senator Andrew Murray, *Committee Hansard,* Melbourne, 25 October 2006, p. 81.

72 See, for example, Mr John Ward and Mr David Knox, Mercer Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, pp. 80-81.

73 Mr Alex Dunnin, *Committee Hansard*, 24 October 2006, Sydney, p. 88.

74 *The Super Secret: How Multiple Accounts Cost Consumers Billions*, A Choice Research Report, November 2006.

> The overwhelming evidence that came in from our research was that there were significant problems with transferring superannuation and consumers not knowing the requirements on them to transfer their superannuation. It became very much a hit and miss sort of thing. They would get 90 points of identification as proof of identification to be able to consolidate their super into one area and then the super fund would not tell them what they needed for the additional 10 points. It is that level of communication that became a problem. Also it is a paper based portability system. It takes a lot of time to do. We cannot see why, in this day and age, it cannot be done real-time and online as a much more efficient process. I think that efficiency of portability will make it easier for consumers to take charge and then be able to consolidate their super. [75]

5.79 IFSA agreed that consolidation could be made easier, and not just in the case of superannuation. While acknowledging that superannuation and life insurance regimes do contain mechanisms enabling product rationalisation, IFSA argued that the respective regimes tend to involve lengthy and costly processes that in fact inhibit product rationalisation. It called for the continued reform of the financial services industry through an extension of financial services reform legislation. The aim would be to introduce a single legislative mechanism to assist financial product providers to maintain modern infrastructure systems to enable their operations to meet the needs of investors.

Exit Fees

5.80 Exit fees have long been identified as a possible barrier to consolidation. In a 2003 report the Senate Select Committee on Superannuation noted strong disagreement over the effect of exit fees on portability, but saw virtue in limiting such fees to the reasonable administrative cost and redemption cost of a rollover/transfer. The committee suggested a role for the Superannuation Complaints Tribunal in keeping exit fees in check.[76]

5.81 During the inquiry the committee heard some evidence of excessive exit fees being levied on accounts, particularly where investors are seeking to leave a relatively old financial product.[77] Choice called for the removal of all exit fees, on the basis that they undermine competition.[78] Representatives from Treasury submitted that, while there was not active consideration being given to their abolition, exit fees were a

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75 Dr Nicholas Coates, Senior Policy Officer, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 42.

76 Senate Select Committee on Superannuation, *Draft Superannuation Industry (Supervision) Amendment Regulations 2003 and draft Retirement Savings Accounts Amendment Regulations 2003,* September 2003, p. 86.

77 See, for example, Mr Graham McDonald, Chairperson, Superannuation Complaints Tribunal, *Committee Hansard*, 5 March 2007, Melbourne, p. 4.

78 Dr Nicholas Coates, Senior Policy Officer, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 42.

matter of ongoing discussion in the banking sector overseas. Treasury went on to argue that some exit fees are more justifiable than others:

> There are some exit fees, not just in Australia per se but in another jurisdiction, that are not related to any real administrative cost. There are other exit fees which may well be related to administrative cost or penalties incurred by the bank when you unwind certain investments—and these probably genuinely need to be paid. I have not done the work on this yet. I accept that it is an important issue, but I think you have to ask those questions in the super area as well—whether there are investments being unwound that justify different penalties over time.[79]

Committee view

5.82 The committee is concerned at anecdotal evidence of some funds deliberately slowing the process of super transfer and encourages APRA to be conscientious in enforcing the new 30 day limit on funds transfers.

5.83 The committee is convinced of the potential for exit fees to undermine competition and discourage portability. The committee believes that exit fees that bear no apparent relationship to exiting a fund should be banned.

Recommendation 15

5.84 The committee recommends that exit fees that exceed the administrative cost of transfer should be prohibited prospectively.

Safeguarding lost superannuation

5.85 Superannuation can become 'lost' when employees change jobs and forget about their old account. When a superannuation fund has not received a contribution from a member for more than two years, or when two written communications have been returned to the fund, the fund must notify the ATO which will then place the name of the account's owner on the Lost Members Register (LMR). The money in such funds is not transferred to the ATO nor any other central fund. It remains with the original super fund or may sometimes be transferred to an Eligible Rollover Fund (ERF) operated either by a super fund or another organisation. Any superannuation monies that are not claimed by the time the consumer reaches age 65 or dies is transferred to state and territory government agencies as unclaimed money.

5.86 According to ATO figures, there were 5,675,510 lost accounts valued at $9.7 billion at 30 June 2006.[80]

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79 Mr Chris Legg, General Manager, Financial System Division, Treasury, *Committee Hansard*, Canberra, 20 November 2006, p. 23.

80 Australian Tax Office, *2005-06 Annual Report*, p. 91.

5.87 The ATO has improved the operation and effectiveness of the current lost member arrangements. A number of measures will be phased in to improve the operation of the LMR and reduce the number of people listed on it, including:

- rationalising existing processes to identify actual lost members including redefining lost members to exclude inactive accounts and more comprehensive reporting from funds;
- allowing accounts of less than $200 to be paid tax free;
- an extensive letter campaign to lost members commencing in 2007 with lost account reviews to be conducted over a four year period through a combination of phone calls and letters;
- establishing a web-based tool through which members can locate their lost accounts using their TFN; and
- by 2009-10, enabling members to electronically request consolidation of their accounts through the ATO website.[81]

Eligible Rollover Funds

5.88 A super fund may transfer the balance of an account into an ERF where it is low, usually about $1000 or less, and where the conditions for super to be considered 'lost' have been met. Where an owner is unable to be contacted, balances of more than $1000 may also be sent to an ERF.

5.89 ERFs were devised as a temporary holding mechanism until a low balance could be rolled over to another super account. While one of the primary purposes of ERFs is to preserve the balance with minimal or no principal reduction due to management fees, information published by Choice indicates that some funds are charging fees of up to 2 per cent. This is considered excessive, given that ERF investment strategies are typically very conservative, and effectively capital guaranteed in their risk profile.[82]

5.90 APRA's most recent June 2006 statistics indicate that total assets in ERFs have risen from $0.7 billion to $5.5 billion since June 1996, increasing as a proportion of total superannuation assets from 0.3 per cent to 0.6 per cent.[83] For the period from June 1997 to June 2006 ERFs achieved an average rate of return of 5.4 per cent. This

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81 The Association of Superannuation Funds of Australia Limited, *Aggregate and individual costs of multiple superannuation accounts*, February 2007, p. 22.

82 *The Super Secret: How Multiple Accounts Cost Consumers Billions*, A CHOICE Research Report, November 2006, pp.25-26, drawing on *Eligible rollover fund disclosure campaign, Final Report*, ASIC, January 2004.

83 APRA, *Insight*, 'Celebrating 10 years of superannuation data collection', Issue 2 2007, Table 1, p. 18.

was less than all other sectors except the retail fund sector, which had 5.3 per cent average returns. The industry-wide average was 6.7 per cent.[84]

5.91 ASIC's November 2006 report titled 'Monitoring superannuation fees and costs' indicated that the costs associated with ERFs are higher than all other types of funds except retail funds, which exhibited the highest average costs.[85]

5.92 Choice cited a report by ASIC that reported most ERFs were not actively looking for the owners of the money they held, and that disclosure details were inadequate. IFF noted that ERFs have no obligation to contact members or transfer a member's accumulated benefit into their active account. It submitted that this is a perverse incentive for ERFs to sit on account proceeds. IFF called for trustees to proactively facilitate consolidation of members' accounts, and for the establishment of a centralised ERF, managed by the government, for the purposes of receiving all lost member accounts.[86]

The Lost Member Register

5.93 The ATO has maintained a register of lost members since 1996. Choice argued that application of the rules regarding lost super by funds is inconsistent, and that partly as a result of this, the data held by the ATO on the LMR is not as good as it could be. These problems make it harder for lost super to be matched with its owner.[87]

5.94 IFF submitted that the ATO needs to more actively and continuously manage the LMR, supported by education and automatic electronic consolidation processes. IFF did not support the reporting of member details to the LMR for members who have been inactive for more than two years where the fund has a current address on file. Where this is the case the member may be inactive, but clearly is not lost and should remain with the fund. This would assist in reducing the number of members treated as lost and ensure that the LMR is used appropriately.

5.95 The need to exercise care in categorising an account as 'lost' was also raised in evidence. REST Superannuation reminded the committee that:

> … [M]any inactive members know where their super is and are actively not making the choice to move it. They do not consider themselves lost, so they

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84 APRA, *Insight*, 'Celebrating 10 years of superannuation data collection', Issue 2 2007, Table 1, p. 41. Figures are for entities with at least $100 million in assets.

85 ASIC, *Report 84*, 'Monitoring superannuation fees and costs', November 2006, p. 10. The figures ASIC reported assume a balance of $50,000 invested in the balanced option with $5,000 invested for the year.

86 IFF, *Submission* 73, p. 48.

87 *The Super Secret: How Multiple Accounts Cost Consumers Billions*, A CHOICE Research Report, November 2006, p. 27.

> are surprised when they are categorised as lost in many circumstances. That is responsible for potentially overstating what is a lost member.[88]

Tax file number matching

5.96 At present, about 76 per cent of super accounts carry with them a nominated tax file number (TFN).[89] The committee heard evidence that in some cases the ATO has matched an individual with a TFN, but the individual's super statement is submitted by the fund without the number being listed. Currently, privacy legislation stipulates that the ATO is unable to provide that number to the fund. The ATO submitted that it was working with the Privacy Commissioner on a solution to the problem:

> There are quite specific provisions that enable us to provide that information to the relevant agencies. We just do not have the legislation that would allow us to provide the information to the funds without breaching privacy … [W]e are looking at whether we can do it in a more streamlined manner. We can certainly write to people and say, 'We've got your tax file number, your fund does not appear to be aware of it and you should let them know.' I would like to do it in a way, as I said, that maximises the number so that we do not necessarily have to rely on people coming back to us. My aim would be to get permission to say, 'If you don't contact us, we'll provide the number to your fund.'[90]

5.97 The utility of the ATO being permitted to pass on TFNs to funds was also acknowledged by Mercer Human Resource Consulting and REST, who summarised the scenario thus:

> That would be the optimal situation to ensure less work for all in the industry, including the tax office, and less downside for members in the withholding of tax.[91]

5.98 In May 2007, the Minister for Revenue and Assistant Treasurer, the Hon. Mr Peter Dutton MP, announced that the Tax Office will be writing to 1.85 million people whose superannuation fund or retirement savings account does not have their TFN. The letter will advise that the Tax Office will provide their TFN to their superannuation fund or retirement savings account:

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88 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, 24 October 2006, Sydney, p. 70.

89 Ms Raelene Vivian, Deputy Commissioner, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 41.

90 Ms Raelene Vivian, Deputy Commissioner, ATO, *Committee Hansard*, 20 November 2006, Canberra, pp. 46-7.

91 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, 24 October 2006, Sydney, p. 69.

> People who receive these letters don't have to do anything. The ATO is simply letting them know they will provide their TFN to the super fund or retirement saving account for them.
>
> Anyone who would prefer the ATO didn't do this, needs to contact them within 28 days from receiving the letter.[92]

5.99 In addition to this recent initiative, the ATO informed the committee of some of the strategies being used to increase the number of super accounts for which TFNs are recorded. It reported that user testing had taken place to understand why TFNs were not being passed by employees to employers, or to funds. One of the most significant reasons is also one of the simplest:

> One of the reasons we have looked at—and this will be changed—is that, at the moment, when an employee starts with an employer, they have to quite specifically elect that the employer has the right to pass the tax file number through. That will be changed so the employee will have to specifically elect that they do not want their tax file number passed through. So, with new employees, that should see a reduction in the number of tax file numbers not passed through.[93]

5.100 The committee was mindful that new government measures from 1 July 2007 will result in 'no-TFN' accounts being taxed at top marginal rate of 46.5 per cent, compared with 15 per cent concessional tax for accounts for which a TFN has been supplied. Representatives from the ATO reported that they were keen to match as many no-TFN accounts as possible, and that an active campaign to employers was being planned:

> We have already started having some very early discussions with some of the clearing houses that provide the funding and some of the payroll providers that the employers use. If, through the way that they do their business, it becomes a natural part of it to provide the tax file number, that will give us the greatest leverage. In terms of the compliance, I suppose the second part is that we would take compliance action against the employers. We are still working out what our compliance strategies might be. But some of the early thinking is that we would start to do some analysis across the member contribution statements, look at where you have large numbers of tax file numbers not coming in from certain employers and use that to guide our risk strategies.[94]

5.101 REST outlined some of the measures his fund had used to get TFNs for members:

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92 'Tax Office to provide tax file numbers to super accounts', Press Release No. 063, 16 May 2007.

93 Ms Raelene Vivian, Deputy Commissioner, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 44.

94 Ms Raelene Vivian, Deputy Commissioner, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 51.

> We have a number of programs that we have been employing, including allowing members to quote that via their product disclosure statements when they first join. Not all members initially fill out a product disclosure statement. Their employer may join them but the employer may not provide the tax file number. We have recently undertaken an exercise where we approached 6 000 of our members who paid a voluntary contribution last year and had not provided us with a tax file number. We provided opportunities via the phone system, via the web and via paper to respond and give us their tax file number. These members, as a result, if they do not give us a tax file number would not be eligible for any co-contributions going forward, despite making voluntary contributions and being otherwise eligible. Just over 2 000 of them provided their tax file number out of 6000.[95]

Committee view

5.102 The committee believes that new government measures will help to reduce the number of super accounts not linked to TFNs, an outcome made especially pressing as tax penalties are levied on no-TFN accounts. The committee in particular welcomes the recent announcement that the Tax Office will be providing TFNs to superannuation accounts for nearly two million people.

5.103 There are 30 million superannuation accounts currently in existence, which is an average of 3 per employed person, including 5.7 million lost accounts containing almost $10 billion. This represents a major structural weakness and inefficiency in the superannuation system that requires an active default solution.

5.104 Nevertheless, the committee expects lost superannuation will remain a real problem for large numbers of members. Good data collection and reporting by regulators and funds will be essential in order to devise further relieving strategies in the future.

Recommendation 16

5.105 The committee recommends that where a tax file number is attached to a lost account it should be automatically consolidated or rolled together into a member's last active account using the tax file number system. The member should have the right to opt out of the system if they wish. This automatic system should not apply to a defined benefit account or an account with a significant exit fee.

95 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, Sydney, 24 October 2006, p.68. A similar response was reported by Mercer Human Resource Consulting, *Committee Hansard*, Melbourne, 25 October 2006, p. 82.

Chapter 6

The cost and accessibility of financial advice

6.1 This chapter examines the cost and accessibility of financial advice. Following on from Chapter 4 the committee discusses the relevance of advice when making investment choices within a fund. It reflects on barriers to the affordability of superannuation advice caused by the breadth of application of the 'advice provisions' in the *Corporations Act 2001* (Corporations Act). It also considers possible remedies to enable the legislative framework to achieve greater proportionality between consumer protection and accessibility of advice. Finally, the committee examines the problem of incomprehensible disclosure documents provided by financial product issuers.

Legislative framework

Licensing of advice

6.2 The Corporations Act stipulates that financial services businesses, including those who provide financial product advice, must hold an Australian Financial Services (AFS) licence.[1] Authorised representatives or employees of AFS licence holders (licensees) are not required to hold a licence themselves. AFS licences are issued and monitored by the Australian Securities and Investments Commission (ASIC), which imposes a number of obligations on licensees and their representatives.[2]

6.3 Individuals or entities that do not hold an AFS licence (or representatives of non-licensees) are generally not permitted to provide financial advice. One exception is accountants, who have been provided with an exemption from the requirement to be licensed when providing advice on the 'establishment, operation, structuring or valuation' of a self-managed superannuation fund (SMSF).[3] This is discussed in Chapter 8.

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1 Section 911A. Section 766A(1)(a) states that a financial service includes the provision of financial product advice.

2 See section 914A of the Corporations Act. ASIC's AFS licence conditions are outlined in Pro Forma 209 and include the following requirements: training for authorised representatives, various financial requirements, dispute resolution and retention of key documents.

3 The exemption only applies to accountants who are members of one of the three major accounting organisations. See ASIC, *QFS 123*, http://www.asic.gov.au/asic/asic.nsf/ASIC+FSR+FAQ+DisplayW?ReadForm&unid=1567F3AC0FAB85C4CA256F65001B317A, (accessed on 28 March 2007).

Definitions of advice

Corporations Act

6.4 The Corporations Act describes the circumstances that constitute the provision of financial product advice, split into two categories: personal advice and general advice. Differing disclosure requirements under part 7.7 of the act apply depending on whether advice is personal or general in its nature. Those seeking to provide services that fall within the act's definition of financial product advice are required to hold an AFS licence.

6.5 Under section 766B(1) of the Corporations Act, financial product advice is defined as:

> ...a recommendation or a statement of opinion, or a report of either of those things, that:
>
> (a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or
>
> (b) could reasonably be regarded as being intended to have such an influence.

6.6 Section 766B(3) of the act defines personal advice as:

> ...financial product advice that is given or directed to a person (including by electronic means) in circumstances where:
>
> (a) the provider of the advice has considered one or more of the person's objectives, financial situation and needs...; or
>
> (b) a reasonable person might have expected the provider to consider one or more of those matters.

6.7 Section 766B(4) defines general advice as: '...financial product advice that is not personal advice.'

ASIC Guidance

6.8 ASIC's policy statement on providing financial product advice indicates that ASIC takes a number of circumstances into account when distinguishing between personal and general advice, for the purposes of administering section s766B(3)(b) of the Corporations Act. In the context of the evidence received during this inquiry, the most significant of these circumstances include:

- whether personal advice was offered to the client or whether it was requested, including requesting advice as to the decision a client should make;

- whether or not the adviser requested information about the client's relevant personal circumstances; and

- whether the advice appears to be tailored to the client's relevant personal circumstances.[4]

6.9 The policy states that *consideration* of personal circumstances is the critical factor:

> If an adviser receives or possesses information about the client's relevant personal circumstances this does not, by itself, mean that any advice given to that client is necessarily personal advice. Whether such advice is personal advice will generally depend on whether the adviser has *considered* (or whether a reasonable person might expect the adviser to have *considered*) that information in providing the advice.[5]

6.10 ASIC has distinguished between financial product advice and factual information on the basis that financial product advice involves a qualitative judgment, whereas factual information is objectively ascertainable.[6]

Disclosure requirements

General advice

6.11 Where the advice provided is only of a general nature, section 949A of the Corporations Act stipulates that the client must be warned that the advice has not taken into account their own objectives, financial situation or needs and the client should consider the appropriateness of the advice in that light. Further, in accordance with sections 941A and 941B the client must be provided with a Financial Services Guide (FSG). The FSG is required to include information on remuneration, commission and other benefits derived from the provision of the advice.[7]

Personal advice

6.12 Of greater concern to the industry has been the disclosure requirements pertaining to the provision of personal advice. Once the provision of advice enters the realm of personal advice, which is essentially the consideration of a person's individual circumstances, the need to provide a Statement of Advice (SoA) is triggered.

Under sections 947B and 947C of the Corporations Act the SoA must include:

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4 ASIC, *Policy Statement 175*, 'Licensing: Financial product advisers – Conduct and disclosure', November 2005, p. 5.

5 ASIC, *Policy Statement 175*, 'Licensing: Financial product advisers – Conduct and disclosure', November 2005, p. 5.

6 Mr Mark Adams, Director Policy and Research, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 62.

7 This requirement applies to all financial product advice. Detailed information on FSG disclosure requirements is contained in ASIC's policy statement 175.

- the advice provided to the client;
- the basis on which the advice was provided;
- information about remuneration, commissions and other benefits resulting from the provision of the advice; and
- any conflicts of interest that may be capable of influencing the entity providing the advice.[8]

6.13 A number of witnesses indicated that these disclosure requirements are too onerous to be applied as broadly as they currently are.

The role and significance of financial advice on superannuation

6.14 The advent of Super Choice and the autonomy it has provided superannuation fund members has brought greater attention to the role of the funds and professional advisers in assisting consumers to navigate their way through the options they now face.

6.15 While most participants in the inquiry agreed that fund members need improved access to some form of straightforward guidance on superannuation, the extent to which detailed personal advice was necessary to ensure optimal retirement outcomes was the subject of dispute. Financial advisers in particular tended to argue that a person's retirement income could be improved with appropriate advice on investment strategies within funds, as well as assisting clients with how best to integrate superannuation into their overall financial affairs. Alternatively, industry superannuation funds in particular responded that default fund arrangements are sufficient for the needs of most ordinary fund members; therefore detailed advice on investment strategies is usually unnecessary and not justified by the expense.

6.16 An examination of these issues provides context for the committee's later discussion on facilitating the provision of accessible general financial advice on superannuation in the context of financial services reform (FSR) disclosure requirements.

Background: the effect of choice

6.17 The implementation of Super Choice has provided consumers with greater autonomy over their superannuation investment, which will potentially create a greater demand for professional advice that is tailored to their own circumstances.[9]

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8 The SoA must also contain a number of other statements, qualifications and warnings. Further detail can be found in ASIC's policy statement 175, pp. 47-49. The most significant of these is the additional requirement under s947D to outline the costs and benefits of switching products, in part or whole, where this course of action has been recommended.

6.18 Perhaps more significantly though, by allowing consumers almost unlimited choice in the marketplace, the Super Choice regime has sought to encourage a more competitive and efficient market in superannuation products. A notable consequence of this competition is for product providers to offer a broader, more diverse range of options to satisfy the requirements of the market, thus adding to the complexity of the choice consumers face. For example, the consumer advocate organisation Choice told the committee that:

> ...competition in financial services is about creating product complexity and creating differentiation in products. That competitive trend is the one that creates the need for advice. You cannot ask a consumer to choose between 200 various investment options on a particular platform and know exactly which one suits their interests.
>
> It is those sorts of moves to try to bang on additional services, to make the product have even more bells and whistles, that generate the need for them to have advice on that product. Faced with 200 options, they need advice on which particular investment option suits their stage of the life cycle on the basis of where they are at that particular point in time. [10]

6.19 The opportunity to exercise greater choice on superannuation, combined with the added complexity of that decision in a competitive market, has focused attention on the importance of financial advice and the manner in which it is provided.

Basic superannuation advice, information and education

6.20 The committee notes widespread agreement across the industry over consumers' need for at least basic professional guidance on superannuation-related matters. Increased choice and complexity are salient factors in this, as referred to above. Importantly, a worrying lack of financial literacy regarding superannuation has also crystallised this view. Addressing this problem is vital.

6.21 A lack of consumer engagement with and understanding of superannuation has carried over from the previous employer-based, passive model of fund membership. Understandably then, the vast majority of contributors to the inquiry agreed with the general proposition that the provision of basic, limited advice on superannuation would be beneficial to fund members. Moreover, there was a broad level of consensus among industry participants that FSR had limited the capacity of advisers and funds to provide this kind of cost-effective guidance and education to

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9 In February 2006 ASFA reported that changes in fund will often continue to be related to employment shifts or an employer's changed default fund arrangements, rather than due to Super Choice. It suggested that a conscious exercising of choice may occur when individuals change jobs and decide to remain in the old fund, when declines in investment returns provoke a shift, or simply when people find the time to change funds. See Ross Clare, *The introduction of choice of superannuation fund – results to date*, AFSA Research Centre, February 2006, p. 15.

10 Dr Nick Coates, Senior Policy Officer Superannuation and Financial Services, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 34.

consumers. The specific nature of the problems associated with the FSR regime, the circumstances under which advice should be provided without costly disclosure requirements, and possible reforms to alleviate current regulatory impediments are examined later in the chapter.

6.22 In order to put the debate in context, the following sections identify the major differences of opinion as to the extent of personal financial advice that superannuation fund members require, or that may be practically offered on a widespread basis.

Is individually tailored financial advice needed?

6.23 As referred to by Choice above, one compelling reason for seeking professional advice is uncertainty in the face of a complex decision. Mercer Human Resource Consulting (Mercer) told the committee that 'many people are scared of making their own decisions without getting advice, because the whole system is so complex'.[11]

6.24 The committee also heard that the provision of personal financial advice was essential to maximising fund members' retirement income. The most contentious claims focused on the superior retirement income that could be achieved by exercising member investment choice within funds on the basis of personal advice, as opposed to remaining in the funds' often conservative default option. Without criticising the adequacy or performance of default options generally, SuperRatings told the committee that approximately 82 per cent of Australians default on their investment and/or insurance structures.[12] However, the argument that it is beneficial to receive professional advice on choosing an optimal investment strategy was made by a number of organisations.

6.25 Promina Financial Services, while also advocating the importance of holistic financial advice, commented on choosing investment options:

> ...the majority of clients who do not seek financial planning advice merely invest in the default investment option already set up for their fund. While these investment options may have sound investment strategies, they may tend to be quite conservative and may not allow a client to maximise the full potential for their savings.[13]

6.26 Financial Planning Association of Australia (FPA) drew attention to large industry funds such as REST and HostPlus, which 'disclose that 99% of members are invested in their default or balanced option, due to the apparent absence of individual

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11 Mr John Ward, Principal and Manager, Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, p. 73.

12 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 12.

13 Promina Financial Services, *Submission 37*, p. 3

advice'. It suggested that this approach was detrimental to members' retirement income:

> Whilst in the current market returns on these funds have been quite good it must be suggested that at least a percentage of those members would have been better off having received advice and placed in less conservative strategies such as Australian share funds or emerging market funds where returns have been up to 50% higher in the current economic environment. In these cases the benefits of receiving professional financial planning advice would most likely result in a greater retirement payout.[14]

6.27 In evidence to the committee FPA reinforced the view that assisting choice through the provision of advice is generally preferable to remaining in the default option:

> There is a lot of evidence to indicate that a number of members are simply not exercising choice or not necessarily thinking about their choice and are opting into default funds which, for all intents and purposes, may work in some circumstances but certainly do not necessarily, in our view, maximise opportunities for members. For example, is there enough choice between a 20-year-old and a 50-year-old in their potential default strategy? Our proposition is that we think too many people are going into default funds and not necessarily understanding or making active choice ... If someone is not confident enough or does not have enough information to make a decision, then advice might be able to help them determine an appropriate investment strategy that is right for their needs.[15]

6.28 While not supporting the provision of yearly advice, the Association of Financial Advisers told the committee that there needs to be 'continual contact' between advisers and their clients to 'keep clients focused on where they started and where they need to be going, because there are lots of distractions in terms of where they should be putting their money'.[16] It emphasised the net benefit of spending on advice: 'people who get advice generally have far better outcomes than people who do not get advice, taking into account the fees that they pay for that advice'.[17]

6.29 In contrast, a number of contributors argued that detailed personal advice is unnecessary for most superannuation fund members, given the adequacy of funds' default arrangements. Members Equity Bank commented that arguments for the provision of detailed financial advice had been exaggerated:

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14 FPA, *Submission 38*, p. 6

15 Ms Jo-Anne Bloch, CEO, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 39.

16 Mr Michael Murphy, Past President, AFA, *Committee Hansard*, 20 November 2006, Canberra, p. 82.

17 Mr Michael Murphy, Past President, AFA, *Committee Hansard*, 20 November 2006, Canberra, p. 84.

> ...for the vast majority of people, the financial advice that they require is very basic. For ordinary working Australians, I am not sure that there has been a case made out for the need for complex financial advice.[18]

6.30 In his submission, Mr Peter Mair also countered the assertion that individually tailored financial advice was critical:

> There are, of course, few aspects of personal uniqueness that have much practical bearing on the way retirees structure their affairs to maximize their financial well being. Some plain advice aimed at the main demographic segments, and made readily-available, could generally break the back of what most consumers need to be told about superannuation and, so forearmed, they would be less likely to be snowed by a self-serving adviser unfairly capturing their confidence.[19]

6.31 Superpartners, a superannuation fund administrator, suggested that the majority of members under their administration were justifiably content with remaining in the default option:

> ...we deal with in excess of five million accounts and most of our membership—in excess of 90 per cent—are really only interested in the default option. That suits them very well. The performance of the default option in most funds has been excellent, as you may have seen. Starting from that perspective, most members of the funds are well served.[20]

6.32 It also emphasised that remaining in the default option did not equate with neglect by the trustee:

> ...the default option does not mean that there is a default of monitoring. The default option, like any other option, under the management and the trustee, must be regularly reviewed and monitored under its statutory investment strategy. The default option is monitored by the trustee board's investment committee on monthly reports, consisting of asset rebalancing on the advice of a professional investment consultant and other fund managers.[21]

6.33 The Australian Council of Trade Unions (ACTU) commented that default options are designed to be appropriate for all members:

> The design of the default fund is supposed to suit anyone. It is meant to be a 'set and forget' option—that is why it is the default fund. You are meant to be able to enter it as a young person and leave it at retirement and have had sufficient return on the investment. Now perhaps someone going for growth

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18 Mr Anthony Beck, Head Workplace Business, Members Equity Bank, *Committee Hansard*, 25 October 2006, Melbourne, p. 31.

19 Mr Peter Mair, *Submission 22*, p. 2

20 Mr Frank Gullone, CEO, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 4.

21 Mr Paul Collins, Manager Legal Services, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 6.

> in the early stages of their life, switching into the balanced fund in the middle and then a more stable option at the end would end up with the same account balance. But the idea of the default fund is to try to make it a set and forget fund for people who do not wish to exercise that choice.[22]

6.34 Industry Funds Forum (IFF) responded strongly to FPA's contention that the default option left fund members worse off than had they received advice, claiming that the argument is 'intellectually bankrupt' by relying on the benefit of hindsight with respect to returns on recently well performing asset classes.[23] It also noted the connection between the relative youthfulness of those funds' membership and their preference for the default option:

> ...REST and HOSTPLUS are unusual funds in this important respect—that is, the vast majority of their members are very young people. For many it is their very first job and they are part-time and casual workers. They earn modest incomes. Nine per cent of a modest income is a modest superannuation amount accumulating in your early 20s or so to a modest superannuation balance. Under those circumstances, most people do not have a great engagement with their superannuation. I think we all know that is true of the general population, but it is certainly true of young people who are decades away from retirement and who have a very small amount of money in superannuation. To expect that those people would seek out a financial advisor is simply unrealistic.[24]

6.35 Mirroring the view of Superpartners, IFF concluded that members of these funds had not been neglected in the absence of personal advice:

> ...both those funds are very mindful of the composition of their membership and have put a lot of effort into determining the default option, knowing that many of their members will go into that option. The investment performance of the default options of both those funds has been very good. If you see all of that in totality, those funds have served their members interests particularly well.[25]

Committee view

6.36 The committee is of the opinion that most fund members will not seek individually tailored financial advice on superannuation, particularly on choosing their own investment strategy. A combination of apathy, inertia and a perception of those with low or moderate fund balances that the cost and effort would not justify the benefits are the principal reasons. Also important is a belief that the fund managers are

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22 Ms Catharine Bowtell, Industrial Officer, ACTU, *Committee Hansard*, 5 March 2007, Melbourne, p. 44.

23 Mr Ian Silk, Convenor, IFF, *Committee Hansard*, 25 October 2006, Melbourne, p. 120.

24 Mr Ian Silk, Convenor, IFF, *Committee Hansard*, 25 October 2006, Melbourne, p. 121.

25 Mr Ian Silk, Convenor, IFF, *Committee Hansard*, 25 October 2006, Melbourne, p. 121. See also HOSTPLUS, Committee Hansard, 6 March 2007, Melbourne, pp. 60-61.

experts and will do a good job. While the committee acknowledges that there is merit in the argument that all members would benefit to some extent from personal guidance on superannuation, the reality is that people cannot be coerced into taking such an active role in managing their superannuation affairs.

6.37 This consumer behaviour is not necessarily irrational; the performance of default fund investment options has been good. Indeed, remaining in the default option may be a conscious decision for many fund members. It is unsurprising that largely disengaged consumers have no qualms about allowing funds' financial investment specialists to set an investment strategy on their behalf, at minimal cost. This is particularly self-evident when investment returns are healthy. Whether the next downturn in the rate of investment returns triggers members' interest in utilising professional advice to become more actively involved in the management of their superannuation investments remains to be seen.

6.38 However the committee notes the concerns that were raised over some members being inappropriately placed in conservative investment strategies. This particularly relates to people who are not close to retirement and could potentially benefit from a more aggressive investment strategy. Although funds with skewed demographic characteristics are able to tailor their default options to cater for their members accordingly, any superannuation fund with a single default investment strategy is prone to attract such criticism. The committee draws no conclusion on the financial benefits of balanced investment options compared with high risk/high growth strategies. Rather, it notes the objection to leaving younger, longer term, fund members in the same default option as near-retirees.

6.39 Health Super informed the committee that their default investment strategies varied depending on the age of the member:

> We ... have a life cycle default option, or strategy, that effectively puts people in long-term high growth up until they are 50, when we write to them to ask them if they want to change their investment option. If not, we dial it down to medium-term growth, which is a 70 growth-30 defensive split, until they are 60. If they then decide to stay in it beyond 60, it will be dialled down to fifty-fifty.[26]

6.40 It added:

> The bulk of people do not make a member investment choice as such, and that is still our experience to date. There are some people who are financially astute who make that member investment choice, but I do not think the vast majority do. We also looked at the demographic of our membership base, and we believe that in the long term growth assets will

26 Mr Christopher Clausen, CEO, Health Super, *Committee Hansard*, 6 March 2007, Melbourne, p. 44. The long term high growth option is a 90-10 split.

> outperform defensive assets, hence the reason for establishing a life cycle default strategy.[27]

6.41 The committee sees merit in Health Super's approach. Whether or not superannuation fund members are actually disadvantaged by remaining in 'balanced' default options, a minor tailoring of default investment strategies may negate a perceived need for advice on this aspect of superannuation. That is, advice that fund members not within a normal investment cycle of retirement could benefit from being in higher risk/higher growth options. This would assist in guiding members in an appropriate direction without trying to encourage the provision of costly financial advice that is unlikely to be sought.

The provision of affordable limited advice

6.42 Despite the difference of opinion over the need for detailed personalised advice and the adequacy of superannuation default options, there was broad consensus over the inadequacy of the current regulatory arrangements to allow for the provision of basic, limited advice on superannuation. The overwhelming criticism of the present legislative framework for the provision of financial advice is the breadth of the definitions of 'financial product advice' under section 766B of the Corporations Act.

6.43 The committee heard that these legislative provisions had restricted fund members' access to advice on issues where consumer protection should not, on the face of it, be a serious concern. For instance, the Australian Bankers' Association (ABA) offered the common view that the requirement for a SoA was triggered too easily, especially when members are merely seeking information on their fund's options:

> The advice regime has unnecessarily restricted the provision of information and education on some financial products, where inadvertently the consumer may provide some basic personal information, and therefore any information provided to the consumer may be considered advice.[28]

6.44 The committee was told that this problem has manifested itself in the context of two types of consumer-adviser interaction:

1. licensed advisers and their (potential) clients: due to onerous disclosure requirements, licensed financial advisers are not able to provide cost-effective advice in response to a straightforward client query; and

2. non licensed entities and superannuation fund members: non-licensed entities (mostly funds, but also accountants) are reluctant to provide information on

27 Mr Christopher Clausen, CEO, Health Super, *Committee Hansard*, 6 March 2007, Melbourne, p. 45.

28 ABA, *Submission 88*, p. 12.

internal fund options and superannuation structures because of concerns over providing non-compliant advice.

6.45 Both these scenerios turn on the wide spectrum of communications that may be deemed to constitute 'financial product advice', with 'personal advice' posing a particular problem for licensed advisers. According to many contributors to this inquiry, the consequence has been that the FSR measures intended to protect consumers have actually prevented them from accessing beneficial free or inexpensive financial guidance from their financial adviser, superannuation fund or accountant.

Advice from AFS licensees and their representatives

6.46 Organisations representing licensed financial advisers told the committee that the range of communications between advisers and their clients that fall within the scope of 'personal advice' is too broad, triggering costly disclosure requirements for even the most limited forms of advice. Consequently, this is inhibiting the ability of licensed advisers to provide consumers with affordable, basic advice on superannuation fund options.

6.47 There was particular concern that 'vanilla' advice on issues such as salary sacrifice, co-contributions, consolidation of small account balances, insurance structures and investment options was not being provided on the basis that it would cost more to consumers than it is worth.[29] This cost, the committee was told, is directly attributable to the extensive disclosure that must accompany personal advice.

6.48 The full gamut of disclosure requirements was generally supported where advice recommends the sale of a product, for instance through a recommendation to transfer an account from one fund to another. It was apparent through the inquiry that there was little support for the same requirements to apply to advice where consumer protection issues are not as relevant.

6.49 For example, SuperRatings told the committee that disclosure for simple, non-sales advice is too onerous:

> ...the licensing requirements of the planners at the moment are too onerous on simple stuff. Co-contribution, salary sacrifice, the investment option and the level of insurance all fall under that category where you need a complete 20-page or 50-page statement of advice to get any of that advice. We are not talking about product advice there. I know it is individual advice, but we are not talking about changing products; we are looking at what is in the best interests of that particular member—whether they can improve their savings or their risk position.[30]

29 See for example Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2006, p. 74.

30 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 13.

6.50 Some submitters used practical examples to demonstrate the nature and extent of the problem. Mercer stated that the cost of straightforward advice was prohibitive for many, with advisers often taking the decision to withhold advice on the basis that it would cost the customer more than it is worth.[31] It suggested:

> ...there should be some greater flexibility. Somebody may come along and say, 'I've got $4,000 in this fund and I've $1,000 in this fund; what should I do?' If they go to a financial adviser, he will charge them $700 minimum to say, 'Yes, I think you should put it all in that fund,' by the time he goes through and analyses all of the person's individual circumstances, which he is required to do. You cannot get it too far wrong if you have $4,000 in one fund and $1,000 in another. The client just wants a five-minute piece of advice to verify that what he is planning on doing makes sense. He does not want to spend $700.[32]

6.51 Bendigo Financial Planning highlighted the case of a typical customer with:

> ...3-5 small existing policies totalling no more than $15,000 and has become frustrated with the lack of any meaningful service from any of the super providers. The customer wants to know the most appropriate place to rollover and consolidate their super and make future contributions.[33]

6.52 Using this example, it outlined the costs associated with the SoA requirements:

> The SOA must include comprehensive comparisons between each "from" fund and the recommended "to" fund, clarifying and explaining differences in costs, fees, benefits, Management Expense Ratios, terms and conditions etc. The standard number of hours to complete any sort of meaningful assessment is around 10-15. Consequently, to simply meet our costs the customer would be required to pay between $1,500 and $3,000 for the work to be completed. Our experience is that customers are not prepared to pay this. Typically they are confused and can't understand why such a simple request can't be satisfied with a simple solution.[34]

6.53 Bendigo Financial Planning concluded that the regime was illogical and detrimental to those it was intended to protect:

> We have found that these customers, often seeing a financial planner for the first time, lose confidence in the financial planning industry and are bewildered as to how a regulatory environment has evolved where a

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31 Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, pp. 74-75.

32 Mr John Ward, Principal and Manager, Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, p. 72.

33 Bendigo Financial Planning, *Submission 44*, p. 1.

34 Bendigo Financial Planning, *Submission 44*, pp. 1-2.

> qualified professional financial planner cannot provide a solution to a simple but important superannuation need.[35]

Advice from non-licensed entities

6.54 The committee also heard that superannuation funds' ability to communicate with their members about options within the fund, or respond to members' enquiries was also hampered by the Corporations Act disclosure requirements. These concerns are outlined below.

When does information become advice?

6.55 Funds expressed uncertainty about exactly what information they could provide to their members, thus tending to limit the provision of advice that could be construed to take into account personal characteristics. The Association of Superannuation Funds of Australia (ASFA) told the committee that the legislative boundaries on advice remained unclear:

> Despite numerous attempts at clarification by [ASIC] and others, the boundaries between information, general advice and personal advice remain uncertain. Notably, the definition of "financial product advice" is very broad and captures a considerable portion of the communications between a superannuation fund trustee and a member.[36]

6.56 REST Superannuation described the effect on its communication with members:

> ...the financial services legislation has limited the way that we and superannuation funds can communicate with our members because of the potential for it to be construed as advice. We and many other superannuation funds that I am aware of have taken a very conservative view in the communications to our members because of the risks involved.[37]

6.57 In particular, REST Superannuation noted the effect on young people with low fund balances:

> Approximately 75% of REST members are under 35 years of age with an average account balance of around $3,500. This is not a traditional market for financial advisers. Yet the importance of seeking basic advice on investment choices and the value of making voluntary contributions early to ensure an adequate level of income in retirement cannot be understated. The limitations of REST's licence restrict our ability to provide education to our members that would assist in making basic decisions yet such early life decisions have a strong impact on future savings. As the barrier to advice is

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35 Bendigo Financial Planning, *Submission 44*, p. 2

36 ASFA, *Submission 68*, p. 18.

37 Mr Damian Hill, CEO, REST, *Committee Hansard*, Sydney, 24 October 2006, p. 64.

> currently too high, members seek advice instead predominantly from family or friends. As result, they may be ill-advised.[38]

6.58 Industry Super Network, however, downplayed the restriction the advice provisions had on funds providing basic information:

> ...funds should not be overly frightened of the regulation in terms of what it prevents them from doing. Most funds want to act in bona fides and give people basic information, true information about their fund. In most cases I find it hard to read the regulations as preventing a fund from adequately and forthrightly explaining their fund and the benefits of their fund. Obviously, there are regulations around it. It is open, therefore, to interpretation. ... But, by and large, I think the funds now can and do communicate pretty well to their members the basics of how their scheme works and how the system works.[39]

Is facilitating a benefit projection 'advice'?

6.59 The committee also received evidence concerning the regulatory impediments to funds offering their members superannuation benefit projections. It is difficult for consumers to reach a decision on the right amount to contribute to superannuation without an approximation as to how much will be required to meet their desired retirement income objectives. To this end, calculating projected benefits on varying contribution levels allows fund members to determine appropriate contribution levels for their future needs.

6.60 Citing the Swedish government's 'orange envelope' model of pension projections and UK funds' legislative obligation to provide annual projections, ASFA suggested that annual benefit projections to members should be facilitated to better 'plan for their retirement and encourage long term savings'.[40] However, ASFA claimed that benefit projections to members are hindered by legal concerns over the provision of potentially misleading information:

> Currently, ASIC Policy Statement 170 places strong restrictions on the use of prospective financial information. These restrictions, combined with concerns over future legal action by disgruntled members, results in the provision of benefit projections by funds being rare.[41]

6.61 Other funds expressed concern that their ability to provide projected benefit calculators has been restricted by ASIC's determination that these projections may constitute the provision of personal advice under section 766B of the Corporations Act. ASIC's policy statement 167 states:

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38 REST Superannuation, *Submission 54*, 5.

39 Mr Gary Weaven, Spokesperson, Industry Super Network, *Committee Hansard*, Melbourne, 6 March 2007, p. 19.

40 ASFA, *Submission 68*, p. 20.

41 ASFA, *Submission 68*, p. 20.

> [PS 167.56] Calculators that provide financial product advice are subject to the licensing provisions, unless an exemption applies. A calculator involves financial product advice if it produces recommendations or statements of opinion that are (or could reasonably be regarded as being) intended to influence the user in making a decision about a particular financial product or class of financial products: see s766B. Whether a particular calculator involves financial product advice will, therefore, depend on the facts of the particular case.
>
> ...
>
> [PS 167.58] It is unlikely that a calculator will produce a recommendation. However, a calculator may produce a statement of opinion that is (or could reasonably be regarded as being) intended to influence the user in making a decision about a particular financial product or class of financial products. Therefore, in our view, it is likely that some calculators involve financial product advice.
>
> ...
>
> [PS 167.61] Calculators typically require the user to input some information about their financial objectives, financial situation or needs (eg information about their initial investment, investment timeframe, ongoing investments, salary, age, attitude to risk). The calculator then uses this information to generate a result. In doing so, the calculator has taken into account at least one aspect of the user's objectives, financial situation or needs. For these reasons, in our view, the financial product advice provided by many calculators is likely to be personal advice.[42]

6.62 The Investment and Financial Services Association (IFSA) expressed its concern over the regulatory treatment of projected benefit calculations:

> It is a pretty sad situation. The industry got to a point about 12 months ago where we had to take calculators off our websites. These calculators allow the individual to put in their own circumstances—they might put in the rate of return, a cost structure, how long they will be contributing, and their age—and the calculator then works out their result. But we had the spectre of the regulator telling us that we cannot trust an individual to pick some figures to put into the calculator. So they could do it on their spreadsheet at home, but if Colonial First State put up a calculator, to use an example, all of the input variables had to be governed by what the regulator said. We are trying to give you advice to the effect that we need some clarification on that front so the calculators can be done personally.[43]

6.63 In a similar vein, the Corporate Superannuation Association argued:

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42 ASIC, *[PS 167] Licensing: Discretionary powers*, January 2007, pp. 25-26.

43 Mr Richard Gilbert, CEO, IFSA, *Committee Hansard*, 24 October 2006, Sydney, p. 100.

> ...there should be a clearer delineation between personal advice and simple arithmetic because there seems to be a lot of confusion in the minds of the regulator as to what simple arithmetic is and what personal advice is.[44]

6.64 It stated:

> Calculators are simply a method of working out compound interest depending on what assumptions are plugged in. If you are a 55-year-old woman and you want to work until you are 65, then the relevant period is 10 years. I cannot see that if you plug 10 years as opposed to 15 years into a calculator it is personal advice. It is just not. It is simply putting one of the factors in the calculation necessary to produce the compound rate of return.[45]

6.65 While the ABA acknowledged this position, it warned of the potential pitfalls of benefit projections:

> There are some advantages for consumers in providing benefit projections. However, this could create an expectation from consumers that the projection will be realised. Consumers tend not to understand the underlying assumptions and parameters used in projections and the impact that a small variation in an assumption can have on overall performance. Furthermore, assumptions may not be borne out in practice for an individual member, so disclaimers required would confuse and thereby limit the value of the projection. While the ABA considers that the current restrictions on forecasts are probably excessive, any form of standardisation is likely to cause difficulties.[46]

6.66 The problems associated with funds' projected benefit tools were highlighted in June 2005 following ASIC's review of online superannuation calculators. It found that putting the same data into 24 different online calculators produced 'widely differing results'. While ASIC acknowledged that differences may be reasonably attributed to factors such as variations in assumptions or methodology, it deemed that consumers were not always provided with the necessary supplementary information to interpret the results meaningfully.[47]

6.67 Following this review and just prior to the introduction of Super Choice on 1 July 2005, ASIC indicated it would provide conditional regulatory relief from holding an AFS licence when enabling consumers to calculate projected benefits using generic financial calculators. ASIC said:

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44 Mr Mark Cerche, Chairman, Corporate Superannuation Association, *Committee Hansard*, 5 March 2007, Melbourne, p. 30.

45 Mr Mark Cerche, Chairman, Corporate Superannuation Association, *Committee Hansard*, 5 March 2007, Melbourne, p. 32.

46 ABA, *Submission 88*, p. 14.

47 ASIC, *Press release IR 05-32*, 'ASIC provides relief and guidance for providers of superannuation calculators', 22 June 2005.

> The relief ... means that providers of superannuation calculators, who meet certain minimum conditions, do not require an Australian financial services licence with an advice authorisation and, if already licensed, do not need to meet the advice conduct and disclosure requirements in Part 7.7 of the [Corporations Act].[48]

6.68 As a response to some of the problems identified by ASIC's review of online calculators, the conditions attached to ASIC's relief include:

- it cannot advertise or promote financial products or be connected to promotional material for a product;
- the default assumptions must be reasonable;
- the user must be able to alter the default assumptions except where statutorily fixed;
- a statement on the calculator's limitations and an explanation of why the assumptions are reasonable must be included;
- an explanation that the results should not be relied on for making a decision about a financial product and that professional financial advice should be sought before doing so; and
- results should be expressed in today's dollars, or with an explanation of the lesser real value of future dollars.[49]

6.69 Given the criticisms of the regulatory approach to calculators aired during the inquiry, whether or not this exemption is satisfactory in the context of an existing member/fund relationship is uncertain.

Avoiding advice in the accountant/client relationship

6.70 Accountants were also of the opinion that the regulatory framework for advice placed them in precarious situations when assisting their clients. This concern is particularly relevant where accountants are providing broad structural advice that incorporates some consideration of superannuation structures, as opposed to advice on choosing products.

6.71 Indeed, CPA Australia suggested that the current arrangements were too focussed on the product selling aspect of superannuation advice:

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48 ASIC, *Press release IR 05-32*, 'ASIC provides relief and guidance for providers of superannuation calculators', 22 June 2005.

49 ASIC, *[PS 167] Licensing: Discretionary powers*, January 2007. [PS 167.50 – 167.83] of the policy statement fully outlines the conditions that apply to this regulatory relief.

> It is essential to recognise the difference between product advice and structural and strategic advice in the area of superannuation. The impact of the current definitions is that it is impossible to provide straightforward information regarding the operation of superannuation outside the systems that have been set up for selling financial products.
>
> ...
>
> In providing appropriate and necessary consumer protection with respect to financial products, current legislation means that strategic advice relevant to the structure of superannuation is confused with recommendations as to entering or exiting a particular superannuation fund.[50]

6.72 It also complained that tax advisers were restricted from providing advice on the taxation implications of superannuation:

> ...there will be tax advisers who are actually breaching the FSRA licensing requirements because they will be talking about the tax-effectiveness of superannuation. Anything that you say that could be seen as an inducement or that could be used by an individual to make a decision regarding how they may or may not spend their money is caught by the licensing requirements. So we are in a situation where you cannot, as a tax adviser even, talk about superannuation being tax effective in terms of deductibility issues et cetera.[51]

6.73 The consequence, according to CPA Australia, is the absence of complete structural financial advice from one source:

> ...some structural advice is in FSR and some structural advice is out and from the consumer's perspective, they can come to an accountant and get some advice about structural issues but they cannot get complete structural advice. And if they go to the planners, they can get investment advice but they cannot necessarily get the structural advice that goes with the other side of it.
>
> We have created a problem where a consumer who is after structural advice as to, 'What are all my options?' actually cannot get it from any one source. What I have found with my clients is that a lot of them want to get someone who can sit back and say, 'From an independent perspective, forget about investments or anything along those lines. These are the options that are available to you and these are the structural issues that you need to think about in terms of what needs to be factored into what is going to be right or wrong for you'.[52]

6.74 With respect to providing advice on self managed superannuation funds, the committee discusses the regulatory exemption for accountants in Chapter 8.

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50 CPA Australia, *Submission 65*, p. 4.

51 Ms Noelle Kelleher, CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 45.

52 Ms Noelle Kelleher, CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 40.

Suggested regulatory changes

6.75 In suggesting regulatory changes to address the problems identified above, the central theme of the evidence was the importance of achieving proportionality between protection and accessibility. In other words, the benefits of consumer protection via financial services reform should not be outweighed by any consequential impediment to the provision of affordable, accessible and beneficial financial advice. If the consumer interest is the principal intent of FSR, then such a deficiency in cost/benefit terms is contrary to the purpose of the reforms.

6.76 For example, REST Superannuation submitted that:

> ...the protection of the consumer is a very important aspect to this. But if the protection of the consumer leads to the inaccessibility to the service, then I am not sure that we have the balance right. You can protect the consumer as much as you like, but if they cannot get access to the service as a result then I think that is a suboptimal position for the consumer.[53]

6.77 FPA also told the committee that the benefits to consumers of the current disclosure regime were being outweighed by the costs associated with compliance. It stated that the benchmark for FSR should be a net benefit to consumers: 'while consumer protection will always be a key objective of financial services regulation, any obligation must always pass a cost/benefit analysis'.[54]

6.78 A number of organisations emphasised the need for the Corporations Act disclosure requirements to bear a more appropriate relationship to the circumstances in which advice is provided. In essence this approach supported the current disclosure regime where substantial, comprehensive, or product switching advice is provided, yet advocated tailoring the regulations to enable less onerous disclosure where the circumstances do not warrant the same vigorous approach to consumer protection.

6.79 In this vein ABA told the committee:

> The ABA considers that the scope of 'general advice' is too broad – there needs to be some proportionality for advice and greater recognition of the value of the provision of information on some financial products as improving the financial understanding of Australians. ...
>
> The ABA considers that where a client sits down and goes through a detailed financial plan with an adviser, taking into consideration the long-term investment needs and circumstances of the client, then clearly the advice regime should apply. However, we believe that the law should better accommodate the provision of information on some financial products, even where a consumer may provide some basic personal information.[55]

53 Mr Damian Hill, CEO, REST, *Committee Hansard*, 24 October 2006, Sydney, p. 64.

54 FPA, *Submission 38*, p. 12.

55 ABA, *Submission 88*, p. 12.

6.80 From this perspective, many proposals focussed on identifying potential legislative distinctions between the different scenarios in which fund members interact with superannuation advice (or information) providers. Suggestions to facilitate the cost effective provision of advice on superannuation are discussed below.

The sales/advice distinction

6.81 One of the most frequent suggestions for appropriately circumventing SoA requirements was to distinguish between advice that recommends the sale of a product and advice or information that does not. For instance, ASFA argued that any redefinition of advice needed to target 'genuine consumer protection issues' such as where advice to switch funds or invest discretionary money is given.[56] In evidence it suggested that:

> ...any communication aimed at explaining internal features of the fund should be permissible without such communications being considered advice. I think that is probably where we would like to see the line drawn in terms of funds being able to communicate with existing members about investment choices or insurance features in particular, without that tripping them into the advice space.[57]

6.82 Mr Geoff Fry of AON Financial Planning and Protection Ltd commented that '...where you don't make a recommendation or mention a specific product it should be general advice'.[58]

6.83 SuperRatings also supported separating advice on the basis of whether a product shift is involved or not:

> ...we should have that sort of advice segmented away from product changes so that, if you are trying to go from product A to product B, it is a separate requirement that the planner must show is in the members best interests. If the planner is simply trying to say, 'You should be salary sacrificing as opposed to paying after-tax dollars into your super fund,' why do you need a 20- or 30-page statement of advice?[59]

6.84 It suggested '...drawing a line between intra-fund advice, or whatever you want to call it, and actual switching as two separate parts of legislation may work'.[60]

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56 ASFA, *Submission 68*, p. 18.

57 Dr Bradley Pragnell, Principal Policy Adviser, ASFA, *Committee Hansard*, 24 October 2006, Sydney, p. 21.

58 Mr Geoff Fry, AON Financial Planning and Protection Ltd, *Submission 17*, p. 2

59 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 13.

60 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 13.

6.85 UniSuper was another fund that expressed the view that different disclosure rules are required for advice that relates to intra-fund issues, as opposed to switching advice:

> We think there are transactional things that members do within a fund. They are about moving an investment choice within their fund, putting in fewer contributions, deciding to make co-contributions and potentially splitting their contributions with their spouse—which are very different from someone deciding whether or not they are going to move from one superannuation fund to another. One is about the information and what is available to them within the fund. The other is deciding between two distinct products. So the advice required for those two distinct products does require full advice.[61]

6.86 The Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007 was introduced into the parliament on 24 May 2007 and passed on 21 June 2007.[62] It included a measure to:

> ...exempt financial services licensees from providing a Statement of Advice in the circumstance where they provide personal advice where that advice does not recommend a product and the adviser does not receive any remuneration for providing that advice.[63]

6.87 Instead, advice of this kind will be required to be documented in a Record of Advice and made available to the client on request.[64]

6.88 The committee also notes that in December 2005, a number of refinements to FSR came in to force. These included amending the existing regime to allow:

- an exemption from providing an SoA where there is an ongoing adviser/client relationship and 'there are no significant changes in the client's personal circumstances or the basis of the advice since the last [SoA] was given'; and
- certain general advice to be given without it constituting a financial service and therefore requiring an AFS licence. This includes instances where the advice is not personal advice and not about a particular financial product and there is no benefit gained by providing the advice. It also includes situations where the

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61 Ms Ann Byrne, CEO, UniSuper, *Committee Hansard*, 5 March 2007, Melbourne, p. 15.

62 See the committee's report on the bill, *Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007 and related bills*, June 2007.

63 Explanatory Memorandum, Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007, p. 20.

64 Explanatory Memorandum, Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007, p. 20.

advice is not personal advice and where it relates to advice given by issuers on their own products.[65]

6.89 Commenting on the latter amendment ASFA wrote that while the change is welcome, it is also limited in its effect:

> The FSR refinement (regulation 7.1.33H) enabling product issuers to discuss features of their own product without the need for a licence is of some assistance. However, the concession does not extend to general education about superannuation, for instance explanation of salary sacrifice. Further, many superannuation fund trustees now hold AFSLs and are not able to use this exemption.
>
> There remain other difficulties with the concession, as it is often the administrator, not the trustee, who is discussing the fund's features. Though should be given to extending the regulation 7.1.33H concession to those authorised to act on behalf of the trustee as well.[66]

Making a recommendation or identifying options

6.90 The Corporate Superannuation Association proposed that a distinction between making a recommendation and merely laying out options to clients be utilised.[67] The ACTU, however, warned that such a distinction would not lead to greater clarity in a practical environment:

> ...drawing a line between advice and a recommendation may well mean that you find yourself with the same grey area where it is difficult for people to draw a line in a practical environment, when they are in the workplace providing information about a particular fund or perhaps at a call centre answering the calls that come in about a particular fund. It sounds attractive but until you saw the regime I am not sure whether it would work or not.[68]

Advice to broad categories or individuals

6.91 From the perspective of superannuation funds, concern over providing targeted information to different categories of membership has hindered their ability to provide members with more relevant information on superannuation. REST called for a mechanism by which advice to broad demographic categories could avoid triggering the personal advice disclosure requirements:

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65 For specific details and conditions see Treasury, *Explanatory Information*, 'Refinements to Financial Services Regulation: Draft Corporations Amendment Regulations', October 2005, p. 5 and pp. 20-21.

66 ASFA, *Submission 68*, p. 18.

67 Corporate Superannuation Association, *Committee Hansard*, 5 March 2007, Melbourne, p. 32 and p. 38.

68 Ms Catharine Bowtell, Industrial Officer, ACTU, *Committee Hansard*, 5 March 2007, Melbourne, p. 45.

> ...if we know that they are a young person, are we taking their personal circumstances into account in changing the communications that we give to them? If there is some mechanism by which we are allowed—and any fund can do this for whatever demographics are appropriate—to target a group and treat them on a group basis and change the communications mechanism, whether it is the content or the delivery style, without falling foul of the personal advice regime, for the vast majority of people who would not ordinarily get advice that is a path to a better solution.[69]

6.92 UniSuper, however, suggested that using cameos may not always be suitable:

> ...if you characterise someone as a particular person—as you mentioned, a 55-year-old single woman—they could require totally different pieces of advice. It would depend on whether they worked full time or part time, what their salary level is, what their expectations are about the rest of their working life, whether they had been married—a whole range of things. Just because someone has a couple of particular characteristics it does not at all mean that they do not need particular advice. Our submission is that you should be able to take those circumstances into account for transactional issues to allow people to be able to make those decisions themselves.[70]

Threshold for disclosure

6.93 Mercer suggested a legislative amendment 'to provide more flexibility in the processes around providing advice in circumstances, for example where the amount involved is below a specified limit or of a minor nature'.[71] In a similar vein, UniSuper suggested that a statement of advice should be required for full retirement planning advice, but not for single transactional issues.[72]

6.94 HOSTPLUS indicated that:

> A narrowing of the definition of personal advice would go some way towards allowing us and our existing staff and existing resources to provide that limited advice that is probably necessary for our members.
>
> ... a transaction based approach, is probably one that we ought to be considering if somebody wants some basic advice on salary sacrifice, rather than our having to get them to have a chat to a financial planner. We think we have the capacity and we think our staff have the skill set to provide that advice, but they are not licensed to do so.[73]

6.95 The committee notes that the Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007 includes a measure to grant relief from the requirement

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69 Mr Damian Hill, CEO, REST, *Committee Hansard*, 24 October 2006, Sydney, p. 66.

70 Ms Ann Byrne, CEO, UniSuper, *Committee Hansard*, 5 March 2007, Melbourne, p. 26.

71 Mercer, *Submission 71*, p. 9.

72 Ms Ann Byrne, CEO, UniSuper, *Committee Hansard*, 5 March 2007, Melbourne, p. 14.

73 Mr David Elia, CEO, HOSTPLUS, *Committee Hansard*, 6 March 2007, Melbourne, pp. 58-59.

to provide a Statement of Advice with respect to advice on investments below $15,000. For superannuation advice, the exemption is limited to advice that recommends consolidating of investments or making additional contributions. The advice will be required to be documented in a Record of Advice, including charges and pecuniary interests relevant to the client as stipulated in section 947D of the Corporations Act.[74]

Tax deductible advice

6.96 Mercer suggested making the costs of financial planning advice tax deductible.[75] The ABA also made this recommendation:

> The ABA recommends that disincentives for accessing financial advice should be removed through providing a tax rebate or deduction for those who seek professional financial advice in relation to superannuation and retirement income products. This approach would acknowledge through public policy the enduring importance of the service of financial advice.[76]

ASIC response

6.97 ASIC told the committee that in some cases the concern over the advice provisions is 'exaggerated'. It stated:

> It is possible under the current regime that we administer to provide information of a strictly factual kind. But we are well aware that in some circumstances the environment in which information is provided is also an environment in which advice is being sought or recommendations are being made. It is that shift from the mere passage of information to engaging with the particular needs of a particular person that attracts the personal advice regime.[77]

6.98 It further commented that re-working the boundaries may be of little benefit:

> ...there are many problems of perception out there. It is not clear that drawing the line in another place would solve those problems. In the regulatory business, there are always arguments about which things sit on which side of the line.[78]

6.99 ASIC also emphasised that its enforcement activity was mostly targeted at where bad advice had been given:

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74 Explanatory Memorandum, Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007, p. 21.

75 Mercer, *Submission 71*, p. 10.

76 ABA, *Submission 88*, p. 15.

77 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 57.

78 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 63.

> ...while there is a fair bit of anxiety in some parts of the industry about this, our own interventions on advice have not terribly often drawn on that fine distinction because our compliance and occasional enforcement interventions have focused on where, in our view, manifestly bad advice has been given. I think that suggests, at least to us, that the problem that we have been concentrating on—which is the real quality of advice in circumstances where a consumer or a group of consumers is actually going to rely on that advice for making important decisions—have not pushed the envelope as far as the distinction. I agree that quite a lot turns on it and that there is still a fair bit of industry uncertainty, but as a matter of regulatory practice we have not pushed hard on the line issue.[79]

6.100 Choice cautioned against any loosening of the disclosure requirements at the expense of consumer protection:

> Some of the considerations under FSR like monetary limits on the statement of advice are attempting to find ways to expand ... advice, but we should not do it at the cost of consumer protection. A paper trail, whether it is a statement of advice or some light version of a statement of advice, is essential for consumer external dispute resolution schemes and for ASIC determining a reasonable basis of advice.[80]

Committee view

6.101 The committee agrees with the general tenor of evidence indicating that FSR disclosure requirements have limited the affordability and availability of straightforward advice on superannuation. It believes that while the consumer protection objectives driving the reforms are appropriate, the overall effect of FSR limiting access to superannuation advice has exceeded any consequential benefit to consumers.

6.102 The committee is aware of the importance of consumer protection in a competitive financial services market, especially since the introduction of Super Choice and the potential for financial planners to exercise greater influence in the marketplace. However consumers are not protected by professional advice being rendered unobtainable at a reasonable cost. From the evidence gathered during this inquiry it is clear that consumers' access to superannuation advice is being hindered in circumstances where consumer protection ought not to be a major concern. This was aptly described to the committee as 'vanilla' advice; guidance the FSR regime should not have been intended to target in the interest of consumer protection. In short, reforms to protect consumers have captured too many advice situations to the detriment of accessibility.

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79 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 63.

80 Dr Nick Coates, Senior Policy Officer Superannuation and Financial Services, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 30.

Triggering disclosure through 'personal advice'

6.103 The most pressing regulatory issue in the realm of superannuation advice is that too many client/adviser communications necessitate the preparation of costly disclosure documents that provide little protective value to the consumer, and may be disregarded anyway because of their complexity and length. Unfortunately, while this problem with the current disclosure regime is readily identifiable, addressing it is a difficult task. ASIC commented that a reworking of the legislative boundaries of what constitutes different categories of advice may not necessarily solve these regulatory shortcomings. Instead, drawing the line indicating where categories of advice start and finish in a different place may simply shift the uncertainty elsewhere. ASIC also pointed out that its enforcement activity had been targeted at poor quality advice, rather than instances of non-compliance with SoA requirements. This suggests that advisers need not be overly cautious when assessing whether or not their communications with a client warrants providing an SoA.

6.104 However when confronted with the choice of being guided by a principles-based approach such as this from the regulator or the black letter law of the Corporations Act, licensees will inevitably err on the side of caution and meet the disclosure requirements in situations where they feel the legislation may require it. Accordingly, the circumstances in which the need to provide an SoA is triggered by legislation should be amended.

6.105 The committee therefore supports the government's proposed measure to exempt advisers from providing an SoA where personal advice is provided that does not involve recommending a product or remuneration for the advice. Although this exemption may not entirely alleviate the problem of disproportionate disclosure requirements applying to 'vanilla' superannuation advice, the committee is of the opinion that its effects should be assessed before other legislative measures are considered.

6.106 The proposal to introduce a threshold for disclosure on a superannuation investment of less than $15,000, where the advice recommends consolidating investments or making additional contributions, is also supported by the committee.

Facilitating information from non-licensed entities

6.107 The committee also recognises the concerns that superannuation funds have over the limits imposed on them by FSR. From their perspective, 'financial product advice' as currently defined in the Corporations Act could potentially capture instances that funds legitimately claim are related to providing informative or educational material. Therefore, in addition to the problem of costly disclosure requirements being triggered, funds have expressed concern that useful superannuation-related information may not be provided at all by funds without an AFS licence.

6.108 The committee reiterates that ASIC's evidence suggested that its priorities did not lie with enforcing these provisions to their limits. ASIC also assured the

committee that factual information may be provided without requiring a licence. However the committee again notes that superannuation funds seeking to comply with the Corporations Act will naturally adopt a conservative approach to the legal risks associated with communicating with their members. Accordingly, two specific areas of uncertainty within the industry ought to be dealt with through further regulatory guidance:

- the ability of funds to provide targeted information to different categories of their membership; and
- the provision of benefit projections.

6.109 On the first matter, the committee is of the view that superannuation funds should be able to provide material that is relevant to their members. At present, funds appear to be uncertain as to whether providing targeted information to their membership constitutes personal advice. The committee does not believe that funds should have to provide exactly the same information to every member in order to avoid being deemed to have provided personal advice. For example, they ought to be allowed to communicate different information to their younger members than they do to near-retirees. Given some uncertainty within the industry, whether or not communications of a targeted nature would constitute 'personal advice' under the Corporations Act is a matter that should be clarified by ASIC.

Recommendation 17

6.110 The committee recommends that ASIC provides guidance to superannuation funds on the provision of targeted communication to separate categories of fund members, so called limited advice, without triggering the need for a statement of advice.

6.111 The committee also believes that the issue of online superannuation benefit calculators requires further consultation and clarification. Even though ASIC has provided regulatory relief for non-licensees to provide generic online calculators, the committee still heard strong criticism on ASIC's regulatory approach to this tool. The difficulty here stems from the fact that the effect of a future superannuation benefit projection can range from being either highly beneficial or extremely detrimental. While an accurate projection can be very useful to assist with deciding on suitable contribution levels, an inaccurate one may cause superannuation fund members to leave themselves without the retirement income they had planned for.

6.112 ASIC's concerns over online calculators are shared by the committee. Regulations pertaining to benefit projections must ensure they are not used as promotional tools for superannuation product providers as this will inevitably lead to the promotion of unreasonable expectations amongst consumers. Further, the committee also questions whether consumers in general possess the requisite financial literacy to use the tool and interpret its results in an appropriate way.

6.113 However the committee is of the opinion that further efforts are required to facilitate superannuation funds' ability to offer its existing members this facility. Having a grasp of the relationship between current contribution levels and future retirement income is an important element of superannuation-related financial decisions. Superannuation funds are an appropriate entity to provide this information. However the evidence during this inquiry suggested that funds view providing benefit projections within the parameters set by the regulator as unfeasible. While the committee is not convinced that ASIC's restrictions applying to online calculators are unreasonable, any stalemate between the industry and the regulator is unhelpful to fund members seeking guidance on their retirement income planning. The committee therefore suggests that this matter be subject to further consultation between the superannuation industry and ASIC, followed by the provision of further regulatory guidance that reflects a suitable compromise.

Recommendation 18

6.114 The committee recommends that ASIC consult further with superannuation funds on the provision of online calculators. Following this process ASIC should provide additional regulatory relief that will better enable funds, without undermining consumer protection imperatives, to use the generic calculator exemption to provide benefit projections for their members.

Regulating accountants

6.115 Situations in which accountants are asked for advice on superannuation are also causing difficulty. Accountants often have long and established relationships with their clients; therefore explaining that certain advice on superannuation must be provided by a separate financial professional can be problematic. This is especially the case where superannuation advice is sought in the context of a broader discussion of a person's overall taxation arrangements.

6.116 The committee recognises the difficulties in resolving this problem. During the course of an accountant/client discussion on retirement planning the line where structural financial advice creeps into the realm of financial product advice is unclear. Any advice from an accountant to favour superannuation over other investments for tax minimisation purposes appears to fall within the scope of section 766B of the Corporations Act. On the face of it, such advice seems reasonable for an accountant to provide, as long as specific financial products are recommended.

6.117 Despite this, the committee is not of the view that accountants should be exempt from holding an AFS licence when providing financial product advice. If accountants wish to provide such advice, they should obtain a licence to do so, as many already do. However the grey areas that clearly exist at present warrant some attention from the regulator. The committee is of the opinion that accountants ought to be able to offer advice on the tax effectiveness of diverting discretionary monies into superannuation without requiring an AFS licence. Therefore, the committee suggests that ASIC should provide accountants with regulatory relief when recommending to

clients that they alter their superannuation contribution levels or consolidate superannuation investments into an existing fund.

Recommendation 19

6.118 The committee recommends that ASIC should provide accountants with relief from holding an AFS licence in circumstances where they advise clients to alter their superannuation contribution levels or consolidate their superannuation investments into an existing fund.

Comprehensible disclosure material

6.119 The committee has previously concentrated on whether disclosure material ought to be provided at all in certain circumstances. However, another important aspect of ensuring that consumers can readily access information and advice on superannuation is the readability of disclosure material when it is provided. Unfortunately, it was widely acknowledged through the inquiry that product disclosure statements (PDS) are often not suitable for general consumption. This is the focus of the committee's discussion in the following section.

Confusing material and the conflicting purposes of disclosure

6.120 Although they may be legally compliant, PDS' that are long, complex, difficult to compare and have key information lacking prominence, do not serve the purpose of communicating effectively with consumers. The public is overwhelmingly put off by such material and anecdotal evidence conveyed to the committee suggested that they ordinarily do not read it. For instance, Superannuation Complaints Tribunal representatives indicated that 'it is just too much to be expected of [consumers] to read that sort of detail'.[81] Equipsuper commented:

> It is a useful discipline for the organisation to go through of course, but a member’s benefit is another thing. Certainly, anecdotally we would be very surprised if many members read all the way through a PDS or even a financial services guide.[82]

6.121 The Institute of Chartered Accountants in Australia (ICAA) wrote:

> For the product manufacturers the FSR requirements have led to Product Disclosure Statements that, while providing and disclosing the mandated information for the consumer, creates complexity and detail that are beyond most consumers’ understanding. PDSs have become risk management tools – as a result consumers are unable to effectively and easily understand the product offering.[83]

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81 Mr Graham McDonald, Chairperson, Superannuation Complaints Tribunal, *Committee Hansard*, 5 March 2007, Melbourne, p. 11.

82 Mr Robin Burns, CEO, Equipsuper, *Committee Hansard*, 25 October 2006, Melbourne, p. 112.

83 ICAA, *Submission 43*, pp. 3-4.

6.122 ASIC admitted that many product disclosure statements are inaccessible:

> ...product disclosure statements are not working as effectively as we would like as consumer communication documents. I think I need to say that there are plenty of examples of good product disclosure statements—and by good I mean written with the consumer in mind, complying with the law, not being unnecessarily lengthy and focusing on the quality of the communication between product issuer and consumer. But it is also true, and we have said this on a number of occasions, that we too, along with industry and consumers, are concerned that there are too many documents which are too long, too confusing and not doing the job of communicating as well as they might.[84]

6.123 Some organisations submitted that concern over legal liability was outweighing any motivation to provide consumers with readable material. In the context of advisers meeting their disclosure requirements to their clients, ICAA:

> FSR has seen the regulation of advice take a "black letter law" approach which results in advisors adopting a checklist mentality to ensuring that everything is covered, rather than to adopt a more preferable consumer-focused approach.[85]

6.124 IFF stated that:

> ...most issuers err on the side of caution to avoid liability and include more rather than less information to mitigate a reasonable level of risk. This encourages more than usual lengthy and unreadable documents that are of little use or protection for the consumer. It also adds to costs, which are passed on to the member. It ignores the core problem faced by all trustees, which is the fact that members either do not read written disclosure material, or if they do read it they are not sufficiently financially literate to understand the information they have been given.[86]

What constitutes consumer-friendly disclosure?

6.125 As demonstrated in the examples above, the committee received plenty of feedback on what constitutes poor disclosure material from a consumer perspective. However, it is more difficult to ascertain what would actually constitute consumer-friendly disclosure material. For instance, what information are consumers generally capable of understanding? Is the material too complex to be approachable anyway? How much are they prepared to read? Would they be any more likely to read five pages than ten, or twenty? What information is relevant to them? Are certain formats more effective than others?

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84 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, pp. 57-58.

85 ICAA, *Submission 43*, p. 6.

86 IFF, *Submission 73*, p. 38.

6.126 ICAA agreed that it would be 'prudent' to research the needs of consumers in this area, but warned that financial illiteracy could affect the usefulness of such research:

> One of the challenges as to any research is for the consumer to know what they are actually looking for in the first place. I think that, even if you research this and ask them what they are after as to superannuation in a PDS, a lot of consumers would not actually know the information they need to be able to make an informed decision. I think that is probably one of the challenges that we actually have. When, with the complexity of superannuation and some other general investments, we say, ‘Can you understand this?’ the response is, ‘I’m not sure why I need to understand this. What is the information that is actually in there?’ I think that is part of the challenge that the industry has.[87]

6.127 Treasury indicated that it has not conducted research in this area as it is the responsibility of the industry. Officers also suggested that the research may not be useful:

> Say you produced results on one or two formats. As soon as you put them out and said, ‘This is a standardised format,’ the type of feedback that you would be getting—and it is the sort of feedback that ASIC has got when it has tried to put out guidance on fairly standardised documents—would be: ‘Well, that doesn’t fit these circumstances and that does not fit those circumstances, so that is not really helpful to the industry.’ After all, their job is to try to communicate with consumers. It is in their interests to produce a document that is readable and friendly.[88]

6.128 In response to a question on notice, Treasury confirmed that no publicly available research had been undertaken in this area. It emphasised the responsibility of product issuers to respond to the needs of their clients within the requirements of the law:

> Treasury does not have any specific information concerning the results of consumer testing on the readability of product disclosure statements. Feedback from industry and the Australian Securities and Investments Commission (ASIC) suggests that there has been no research at an industry level concerning what proportion of individuals can or cannot read disclosure documents generally.
>
> While Treasury has been informed that individual financial service providers do test different versions of their disclosure documents on consumers, the results of these tests are confidential and limited to the documents of that particular firm. ASIC has not tested the readability of

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87 Mr Hugh Elvy, Manager Financial Planning and Superannuation, ICAA, *Committee Hansard*, 7 March 2007, Sydney, p. 21.

88 Mr David Love, Manager Investment Protection Unit, Corporations and Financial Services Division, Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 13.

product disclosure statements on consumers, but encourages the industry to undertake this activity.

Ultimately, product issuers are responsible for ensuring that their disclosure documents are presented in a clear, concise and effective manner in accordance with the legislative requirement. Where disclosure documents are not presented in this way, the effect may be that the particular product is less attractive to consumers relative to other products, which is contrary to the commercial interest of product providers.

6.129 ASIC suggested to the committee that, over time, the different objectives of PDS' could be appropriately resolved through consultation:

> ...we have signalled our willingness to engage with the issuers of documents to try to get to a point where we communicate to industry what it is that would improve that as well as about the regime that we administer. There are three purposes served by an ordinary product disclosure statement. One is to actually market a product. One is to comply with the disclosure laws that we administer. The third, and I do not want to be disparaging about this, is to manage the liability of the issuer. In that environment, where there are three potentially conflicting objectives in mind, I think it is not unnatural that it has taken a time to get a degree of comfort on the part of industry and on the part of the regulator about what is required. I am not sure that one can legislate or change the legislative settings anymore than has been done, and I am reasonably confident that, going forward, a good, focused, three-way discussion between the regulator, industry and consumers will lead us towards better disclosure documents.[89]

6.130 Despite a lack of objective, empirical guidance in this area, two basic requirements to improve disclosure material in PDS' have been identified. These are brevity and comparability.

Short-form PDS

6.131 In December 2005 the government allowed financial product issuers to supply a short-form PDS to satisfy the requirements of the Corporations Act. This contains a summary of the information required in the PDS. However, product providers still need to prepare an 'ordinary' PDS and make it available to retail clients on request. The short version is an optional extra.[90]

6.132 A short-form PDS is a preferable means by which to communicate with clients. However from a legal perspective there is little incentive for issuers to provide clients with a short form PDS given the potential for an increased risk of non-compliance with disclosure regulations.

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89 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 58.

90 Treasury, *Information Package*, 'Refinements to Financial Services Regulation', p. 4.

6.133 From a resources perspective, there is also little incentive to produce a short-form document when the longer version is required anyway. On this basis, Mercer Human Resource Consulting queried the likelihood of trustees making use of this initiative:

> ...any Trustee who elected to prepare and distribute a short-form PDS, would also have to go through the cost and time commitment to develop and maintain a long-form PDS.[91]

6.134 By ASIC's admission few issuers have taken the opportunity to offer their clients the abbreviated version:

> ...there has been a relatively slow take-up of the short-form prospectus provisions. However, that is also connected with refinements that are coming up in relation to allowing for incorporation by reference of information within prospectuses. Industry has indicated that it also needs incorporation by reference to make the short-form prospectus measures work more effectively.

6.135 Industry Funds Forum wrote: 'IFF submits the short form PDS option has failed to resolve [the] issues. The fact that only one short form PDS has been issued speaks for itself'.[92]

6.136 Unisuper implied that adopting a risk-averse attitude to short-form PDS' was not in the consumer's best interest:

> ...anxieties about the legal risk inevitably come to bear, so I suppose there is a bit of a reluctance to be the first mover in that area. By and large I think we would be quite happy to put our toe in the water on things like that, and in the advice area as well. If there is some ambiguity why not exploit it in the interests of the consumer rather than erring on the defensive all the time...[93]

6.137 IFF emphasised that prominence of key information, rather than document length, was the most important consideration:

> We would prefer a more consumer-friendly FSR regime. That does not necessarily indicate, as some of the submissions to the inquiry would have it, that the disclosures currently provided should be stripped away and, to put it baldly, that people have a much reduced amount of paper to read. We would argue that the objective should be that important information should be prominently and comprehensively displayed to members rather than start from a proposition that we should get this down onto half a page of paper.[94]

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91 Mercer, *Submission 71*, p. 20.

92 IFF, *Submission 73*, p. 38.

93 Mr Paul Murphy, Executive Manager Marketing and Business Development, Unisuper, *Committee Hansard*, 5 March 2007, Melbourne, p. 20.

94 Mr Ian Silk, Convenor, IFF, *Committee Hansard*, 25 October 2006, Melbourne, p. 122.

6.138 Industry Super Network warned that extra regulation in this area may not be beneficial:

> Any apprehension and concern about the volume of material has to be balanced against any apprehension and concern about what any new regulation might do. It has not necessarily been the case that the situation has improved when a new regulation replaces an old regulation nor can there be a presumption that that would be the case. It is a very complicated area and it is difficult to regulate adequately. Any re-regulation needs to proceed from very pure motives and a very clear insight as to the national interest and interests of individual consumers.[95]

Standardisation

6.139 Since 1 July 2005, in accordance with *Corporations Amendment Regulations 2005 (No.1)*, PDS' for superannuation products have been required to include a standardised fees and costs template.[96] Previously, information on fees could be presented as issuers deemed appropriate, making comparisons difficult. This measure was intended to address that problem.

6.140 Despite the change, the committee heard evidence that it is still difficult to make fee comparisons between superannuation product providers. ICAA commented that:

> ...the issue of how fees are templated and provided needs to be addressed more. It is almost impossible, basically, for the average consumer to look through three or four PDSs and understand what the fees are.[97]

6.141 Aside from fees, the government has not mandated that other information needs to be presented in a standardised fashion within the PDS. ASIC told the committee that extending mandated standard forms of disclosure would not necessarily improve readability:

> ...historically, there have been some problems with the consumer-effective mandated content or lengths ... the assumption on which we are proceeding is that it is better if these things emerge over time. For example, the old prospectus regime had a mandated series of disclosures, and it was not always obvious that complying with those mandates was in the interests of

95 Mr Gary Weaven, Spokesperson, Industry Super Network, *Committee Hansard*, 6 March 2007, Melbourne, p. 19.

96 ASIC, *Information release 05-19*, 'ASIC provides answers on some fees and costs questions', 10 May 2005.

97 Mr Hugh Elvy, Manager Financial Planning and Superannuation, ICAA, *Committee Hansard*, 7 March 2007, Sydney, p. 20.

> good or accurate communication. I do not think we see a case at this stage for changing that fundamental setting.[98]

6.142 It also contended that comparability was not always practicable:

> The objective of comparability is not evenly achieved across the spectrum. In some cases it is quite difficult for that to occur. We really need to be talking about similar product types being offered to consumers whose objectives are similar ... [W]e have asked ourselves whether there is a case for a more standardised disclosure of risk, but that is something you would not want to close down by standardisation because it is very particular to the individual product and the individual issuer.
>
> Similarly, the other leg of what we say is important here is for people to understand in a clear way what they are buying and, given the variety of products on the market, that is difficult to standardise. It would seem better that we drive disclosure towards clear and effective communication of what people are being offered, how much they are being asked to pay for it and what risks are associated with it than to try and standardise those things in a way that works in fees. It is unclear whether that would work as well outside the fee area.[99]

Committee view

6.143 Consumers would benefit greatly from shorter, more comprehensible and more comparable product disclosure statements. While the objective of more consumer-friendly disclosure is not subject to disagreement, the means by which it may be achieved are. Short-form PDS' have not worked because there is little or no incentive for product issuers to supply one. Further, lengthy documents are only problematic where their length itself makes the key information they contain difficult to find. Achieving comparability through mandated standardisation also has its deficiencies, as ASIC pointed out. Finding a one-size-fits-all model that could be practically used by product issuers offering a diverse array of financial products could potentially create more problems than it solves.

6.144 The committee is of the view that the readability of PDS' could be improved by ensuring that important information is prominently displayed, in summary form, at the front of the document. This would enable those seeking to make a comparison between products to do so without needing to endure rifling through the entire document. The committee strongly encourages superannuation product issuers to improve their PDS' in this fashion.

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98 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 58. See also evidence from Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 12.

99 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, pp. 58-59.

6.145 If this cannot be achieved by the industry of its own volition then it should be mandated by government. In doing so, it would be advisable for Treasury or ASIC to have undertaken market research on the readability of PDS' to ascertain the most consumer-friendly way to present such material in a standardised format. Such research should be conducted as soon as possible.

Recommendation 20

6.146 The committee recommends that the government conduct market research on the readability of superannuation product disclosure statements with the goal to introduce simple, standard, readable documentation.

Chapter 7

Remuneration models for financial advice

7.1 This chapter analyses the effect of different remuneration models on the standard of superannuation advice. The committee discusses potential conflicts of interest in commission-based remuneration models. It also notes issues associated with paying ongoing trailing commissions, the use of approved product lists and 'tied' adviser relationships. Remedies to improve the quality of superannuation advice are then examined including suggestions to ban commissions and shelf fees, improve disclosure of conflicts of interest, mandate a higher standard of advice and facilitate the provision of fee-for-service advice. Finally, the committee discusses the important role of education and financial literacy to equip current and future superannuation fund members with the capacity to navigate the new superannuation environment.

Legislative standard for financial advice

7.2 The standard imposed by the *Corporations Act 2001* (Corporations Act) is for there to be a reasonable basis for advice. In meeting this standard, section 945A stipulates that the entity providing advice must comply with the suitability rule, which is comprised of the following three criteria:

(i) knowing the client's personal circumstances;

(ii) knowing the product or subject matter the advice is given on; and

(iii) ensuring that the advice is appropriate to the client.

7.3 ASIC has indicated that 'personal advice does not need to be ideal, perfect or best to comply with the Corporations Act'.[1] Therefore, so long as disclosure requirements are met, it is legally permissible for an adviser to recommend a product privately knowing it is not the best option for the client.

7.4 The standard of advice on superannuation has been most questionable where clients have been advised to transfer their fund balance from one product to another. The introduction of ASIC's policy statement on providing financial product advice states that:

> In the case of advice to replace one product with another product (or to switch between investment options within a financial product), we consider that consideration and investigation of both the new product (or option) and the old product (or option) is generally required under s945A(1)(b).[2]

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1 ASIC, *Policy Statement 175*, 'Licensing: Financial product advisers – conduct and disclosure', November 2005, p. 37.

2 ASIC, *Policy Statement 175*, 'Licensing: Financial product advisers – conduct and disclosure', November 2005, p. 31.

7.5 It indicates that switching advice would not be appropriate if there is no net benefit to the client in doing so:

> In the case of advice to replace one product with another product (or to switch between investment options within a product), we consider that the advice will generally be inappropriate if the providing entity knew (or ought reasonably to have known) that the overall benefits likely to result from the new product (or option) would be lower than under the old product (or option).[3]

7.6 In evidence, ASIC reiterated the importance of enquiries being made into the exit fund:

> The AMP enforceable undertaking deals with that issue. That is one of those examples where I think there is still some industry anxiety about obligation of inquiry. We are sympathetic where it is quite difficult to get details about the possible exit fund, but we have stayed firm that you cannot provide people with good, reliable advice to go from A to B without knowing something about A as well as B.[4]

7.7 The examples of unreasonable advice in a 'switching' scenario were highlighted by the results of ASIC's shadow shopping survey on superannuation advice, released in April 2006. Most significantly, ASIC reported that unreasonable advice was between three and six times more likely where a conflict of interest was present.[5]

Remuneration models

7.8 As referred to in the previous chapter, the majority of fund members do not seek professional advice on the management of their superannuation balance. For those who do seek professional guidance, there are a number of ways in which the adviser can be remunerated for it. These include fee-for-service and commission-based payments, the latter being utilised in the financial advice market with a few different variations.

Fee-for-service

7.9 Fee-for-service remuneration is an up front payment negotiated on the basis of the agreed value of the advice provided, which is normally determined by, and charged at, an hourly rate. This reflects the arrangement clients generally have with other professional advisers such as lawyers. Advisers being paid through this

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3 ASIC, *Policy Statement 175*, 'Licensing: Financial product advisers – conduct and disclosure', November 2005, p. 32.

4 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 70.

5 ASIC, *Shadow shopping survey on superannuation advice*, April 2006, p. 2.

arrangement usually rebate back to their clients any commissions paid to them by the funds.

7.10 As referred to in the previous chapter, rigorous disclosure requirements have rendered this an expensive payment option, particularly where it cannot be paid out of a person's superannuation account balance.

7.11 Some superannuation funds have established a mechanism whereby the cost of fee-for-service advice may be deducted from account balances. For instance HostPlus reported that:

> ...from 1 January 2007, members will have the ability to choose an additional method of payment for financial planning advice for superannuation only. Members will be allowed to deduct a set amount from a member’s account in order to pay for that advice.[6]

7.12 REST Superannuation outlined its own model for outsourcing the provision of advice:

> REST has engaged the services of Money Solutions Pty Ltd to offer personal advice to our members while operating under its own personal advice licence. This model allows members access to one off coaching for individual issues rather than a full financial plan. We believe that it is appropriate to allow for payments for such advice to be deducted from a member’s superannuation account, subject to the sole purpose test rules. Our experience shows that over 92% of our members who receive single issue superannuation advice under this arrangement do not wish to go to a full financial plan and consequently would go unserviced or be poorly serviced by the traditional financial planning industry.[7]

7.13 As REST mentioned, the capacity of funds and members to utilise this payment option is limited by the sole purpose test. Section 62 of the SIS Act stipulates that superannuation fund trustees must maintain the fund for the benefit of members. In the context of deducting fees from members' accounts, the Australian Prudential Regulatory Authority (APRA) has indicated that superannuation fund trustees are 'not permitted to apply members' contributions or fund assets for services provided outside the core and ancillary purposes'.[8]

7.14 Account deductions for advice on superannuation only are permitted on the basis of the connection between that service and the core purpose of the fund. APRA's guidance states:

> 41. It is open to trustees to develop features of their fund which add value to, or differentiate it from, other funds. For example, fund sponsored

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6 HOSTPLUS, *Submission 63*, p. 7.

7 REST Superannuation, *Submission 54*, p. 5.

8 APRA, *Superannuation Circular No. III.A.4*, 'The sole purpose test', February 2001, paragraph 38.

> member awareness, education and financial advice programs, targeted at fund specific issues such as benefit features (including insurance options, the making of binding death benefit nominations etc) or investment choices offered in the fund, may be appropriate. ...
>
> ...
>
> 43. Financial planning is now a service which many trustees are considering offering to members. As noted in paragraph 41, if the service is aimed only at a member's interest in the fund, such services would generally fall within the sole purpose test. If, however, broader advice is offered, it would be inappropriate for the cost to be borne by the fund.[9]

7.15 A number of organisations expressed uncertainty as to the scope of the sole purpose test with regard to deducting the cost of financial advice from member accounts. This matter is discussed later in the chapter in the context of providing a remedy for the provision of conflicted advice.

Commissions

7.16 Commission-based payments are paid by retail and some industry superannuation funds to financial advisers in exchange for distributing their products in the marketplace. From the funds' perspective, paying commissions is more effective than deploying numerous salespeople to go out and sell their product. Significantly though, commissions are also a useful mechanism for remunerating advisers for the cost of providing advice without their clients needing to find the money from elsewhere, as is generally the case with fee-for-service advice. In this way, paying for advice via commissions is appealing to those who cannot afford costly up-front advice from their discretionary monies.

7.17 In a superannuation context, commission payments are either deducted from a member's account at the beginning, or as a regular payment that may continue for as long as he or she remains in the fund. This latter variety is referred to as a trailing commission. Advisers may be paid a mixture of up-front and trailing commissions.

7.18 ASIC's consumer website outlines the normal range paid in commissions as follows:

> Entry fees for standard investment and superannuation products range from nil to 5% of the amount you invest. About 2% to 3% is common, so you would invest only $98 or $97 of every $100 you pay. Trailing commissions range up to 1% each year, so you would pay $1 every year for every $100 in your account.[10]

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9 APRA, *Superannuation Circular No. III.A.4*, 'The sole purpose test', February 2001, paragraphs 41 and 43.

10 ASIC, *Consumer website*, 'How commissions affect you', http://www.asic.gov.au/fido/fido.nsf/print/how+commissions+affect+you?opendocument, (accessed 19 April 2007).

7.19 Trailing commissions are generally deducted on an annual basis on the premise that a financial adviser, while receiving an ongoing commission payment, will continue to provide his or her client with ongoing financial advice with respect to that fund. Trailing commissions may also result in lower up-front commissions. Some trailing commissions may be able to be switched off or 'dialled down', that is reduced. Many advisers also make arrangements with their clients to rebate trailing commissions earned from the fund back into the member's account.

Sales-based remuneration and the quality of advice

7.20 Commission-based remuneration was the subject of extensive criticism, principally from the industry fund sector, throughout the inquiry. The dual purpose served by commission-based remuneration of funding the cost of advice and serving as a distribution mechanism for the funds raised a number of issues pertaining to conflicts of interest and the quality of advice.

Commission-based conflicts of interest

7.21 A number of organisations expressed the view that remunerating advisers for sales and advice with the same payment mechanism generates a substantial conflict of interest for advisers, often leading to the provision of advice that is not necessarily in the client's best interests. Commissions encourage advisers to recommend, in spite of quality or suitability, superannuation products that pay commissions over those that do not or to favour products that pay high commissions over those paying more standard rates. The committee notes that products offering higher than usual commissions in return for distribution to clients are not generally able to compete on the basis of quality, as the Westpoint collapse demonstrated. However, it is also worth noting that none of the major financial product platforms had Westpoint, Fincorp or ACR on their approved product lists.

7.22 Corporate Superannuation Association offered the view that commission-based conflicts of interest are inevitable:

> You cannot expect a person who has a family to feed to be dispassionate and advise somebody who comes in where there is no product to be sold, because the person is currently perhaps in UniSuper or Rio Tinto, which are very superior funds. If you go into the average planner and get some advice, if they knew their product and they knew your product, they would say, ‘Well, you may as well leave now.’ But that is not what happens.[11]

7.23 Industry Super Network asserted that 'unsuspecting consumers' were let down by a system of remuneration that is geared towards promoting lucrative sales rather than the best advice:

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11 Mr Mark Cerche, Chairman, Corporate Superannuation Association, *Committee Hansard*, 5 March 2007, Melbourne, p. 33.

> While consumers believe they are paying advisors for professional advice, financial planners are actually paid a sales commission by the financial institution which employs them or which provides the product. Most financial planners do not recommend that consumers consider putting their superannuation in an industry super fund, despite the fact that this would in many cases provide the best retirement outcome for consumers. The structure of commissions ensure that they promote good sales rather than good advice and we submit that recent investigations by ASIC demonstrates that current legislative obligations fail to adequately protect consumers.[12]

7.24 Choice estimated that $772 million in commission was paid on compulsory superannuation investments between March 2005 and March 2006, with an additional $93 million paid in ongoing trailing commissions during that period.[13] Choice commented:

> These remuneration structures can link financial advice about superannuation with how the adviser is remunerated. Fund managers compete with each other based on the commissions and other enticements that they can offer planners to promote their superannuation products. These incentives can distort how advice is framed to consumers and this can lead to inappropriate advice.[14]

7.25 Choice told the committee that the payment of commissions on superannuation products has evolved from the old life insurance model where products needed to be distributed, or sold, using this remuneration mechanism. However, Choice argued that this approach is no longer appropriate in the context of superannuation: 'A compulsory system should not need distribution mechanisms'.[15]

7.26 Superpartners submitted that industry funds were often disregarded by advisers as they do not pay commissions:

> Industry funds do not generally pay commissions to personal advice licensees which results in consumers not being advised about the option of moving to an industry fund. The consequence is that personal superannuation advice is not given on the basis of the product that is most suitable for the client's needs.
>
> ASIC has conceded that it "made no secret" that the commission model has meant many advisers did not advise their clients of industry funds. The experience in the United Kingdom with pension fund switching carries a salutary warning of the dangers of commission-driven advice. The potential influence of a commission in advising consumers about switching presents

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12 Industry Super Network, *Submission 77*, p. 8.

13 Assuming an average commission of 3% and industry average trail of 0.35%.

14 Choice, *Submission 75*, p. 4.

15 Dr Nick Coates, Senior Policy Officer Superannuation and Financial Services, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 31.

> industry funds with a structural competitive disadvantage with retail funds.[16]

7.27 Other organisations argued that commissions provide fund members with access to advice that would be otherwise unobtainable. For instance, the Financial Planning Association of Australia (FPA) indicated that commission payments are an effective remuneration method for clients to use when accessing ongoing advice:

> ...from a commission point of view that there is a huge amount of ongoing advice required in some cases. You can often put a set and forget strategy in place, but in some cases—and we can talk through this in quite an amount of detail—you do need to review your strategies, you need to look at your contribution levels, you might like to look at your asset allocation, there might be market movements, or in fact you might simply want advice to say, 'Don't do anything.' So that commission is not only about the initial piece of advice and a product. It is also about providing ongoing advice, being able to ring your adviser whenever you like, being able to ask them questions across a whole range of different issues without necessarily having to sign a cheque.[17]

7.28 This position reflects the view that conflicted advice, properly managed to ensure that appropriate advice is still given, is preferable to no advice on superannuation at all. Or in other words, to prohibit commissions because of a potential for inappropriate or inferior advice would be an overreaction to a manageable problem.

ASIC's shadow shopping survey and related action

7.29 In April 2006 ASIC released the results of its shadow shopping survey on superannuation advice, which surveyed 259 individual advisers and assessed the standard of their advice. Significantly, ASIC reported that advisers are between three and six times more likely to provide unreasonable advice where a conflict of interest is present. It identified as major problems the following practices:

- not examining existing funds before recommending new ones;
- not disclosing the reasons for recommended action; and
- not disclosing the consequences of switching funds.[18]

7.30 Perhaps most worryingly, ASIC concluded that most clients who had received poor advice did not realise it was so.[19]

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16 Superpartners, *Submission 67*, pp. 13-14.

17 Ms Jo-Anne Bloch, CEO, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 38.

18 Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission*, August 2006, pp. 9-10.

7.31 Following this exercise, in July 2006 ASIC accepted an enforceable undertaking from AMP Financial Planning Pty Ltd to modify the way in which it provides financial advice to customers. ASIC reported that a significant proportion of AMP planners had been advising clients to shift from rival funds into AMP products without disclosing a reasonable basis for the advice. As a consequence AMP undertook to change a number of its internal procedures and offered to review its clients' advice.[20] Nevertheless, AMP disputes the conclusion that the advice was inappropriate in all of the shadow-shopping cases.

Trailing commissions: paying for ongoing advice

7.32 One form of commission payment attracted particular criticism during the inquiry: trailing commissions. This remuneration model operates on the basis that an annual commission is paid from the fund to the adviser in return for ongoing access to superannuation advice.

7.33 The focus of criticism of trailing commissions related to value for money; the payments could continue indefinitely without a commensurate provision of advice in return. For example, Superpartners told the committee that trailing commissions often cost more than the value of the advice provided:

> What we are concerned about ... is the issue of trailing commissions going on and on, in relation to advice that may have been given many years ago, that the member is not benefiting from it and that the advice has no application to the current circumstances of that member.[21]

7.34 It submitted that such remuneration worked against the interests of the member:

> A fundamental premise of transparency of commission disclosure is that the commission should properly represent a fee for service. ... Commissions that amount to a persistency or volume bonus are incompatible with the purpose of superannuation to provide retirement incomes in trust for the benefit of the members. [22]

7.35 Treasury commented that trailing commissions did not ensure a connection between the value of advice and its cost:

> ...there should be a connection between the value of the advice given and how much you are paying for it through the commission. The real difficulty comes when you have things like trailing commissions, where there does

19 Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission*, August 2006, p. 10.

20 Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission*, March 2007, pp. 8-9.

21 Mr Frank Gullone, CEO, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 4.

22 Superpartners, *Submission 67*, p. 23.

> not seem to be any connection between the value of the advice provided and how much the adviser is being remunerated. That is an issue that the government—as well as this committee and many others in the community—have identified as a significant problem for consumers in the marketplace. The government have said that the industry has to examine this and has to look at how it is going to deal with this particular situation. Within that context, that is why the sales recommendations idea has been developed—it is in order to try to make what is really happening much more transparent to consumers.[23]

7.36 In defence of the practice, CPA Australia told the committee that the majority of planners rebate commission fees to their clients.[24] MLC told the committee that the difference between commissions and fees 'is not that great'.[25] Instead it is mostly a difference in transparency rather than cost:

> The difference between a commission and a fee is that a fee gives a client two fundamental rights. One is to negotiate that fee up-front and agree it and understand it with the adviser. The second is that they can stop paying it if they no longer think they are getting value for it. It could be exactly the same amount of money, the same dollars: two per cent is two per cent, whether it is a fee or a commission. It is simply that the client can see a fee more clearly and they can stop it if they do not like it at a future point in time.[26]

7.37 The Association of Financial Advisers (AFA) described trail commissions as 'another form of remuneration' that enabled ongoing advice:

> Whether the client wishes to pay for it by a monthly debit or whether they wish to pay for it out of their investment, that is their choice. I think if we give clients the choice of how they want to pay for the advice that they receive then that is a lot easier than legislating for it.
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> ...
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> There is an ongoing need for advice. Under the regulations we are supposed to review clients every year. Personally, it is not my favourite thing because I think superannuation particularly is a long-term investment. However, within that environment, as I said, the circumstances will change. There is a need for insurances earlier on and there is a need for, I suppose, a specific investment profile if you look at the requirements of the legislation. But I hold with a view that is really trying to keep the clients focused on their end goal and maintaining a source of information and education all the way through.[27]

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23 Mr David Love, Manager Investment Protection Unit, Corporations and Financial Services Division, Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 17.

24 CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 48.

25 Mr Steve Tucker, CEO, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 81.

26 Mr Steve Tucker, CEO, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 81.

27 AFA, *Committee Hansard*, 20 November 2006, Canberra, p. 81.

7.38 Fiducian Portfolio Services also argued that the cost was justified by the benefits:

> Superannuation and retirement planning involves far more than simply looking at fees. Professional retirement planning advice to a client will involve consideration of issues such as the client's retirement goals, the breadth and depth of investments based upon their risk profile, salary sacrifice strategies and determining adequate levels of risk insurance.[28]

Approved product lists

7.39 The problem of advisers preferring to recommend superannuation products returning commissions appears to have manifested itself through AFS licensees' approved product lists. Ostensibly, approved product lists function as a risk management tool for licensees, ensuring that their authorised representatives only recommend products into which the licensee has conducted appropriate checks. This level of control avoids the legal risk associated with individual advisers recommending products that his or her licensee would not itself have the confidence to recommend.

7.40 However approved product lists may also be used as a way of sidelining superannuation products that do not pay commissions or shelf fees,[29] or do not benefit the vertical integration strategies of the licensee. Industry funds feel particularly aggrieved that, despite offering competitive returns to members, they are notably absent from the approved product lists from which licensed advisers may recommend specific products. Even if an adviser wishes to, he or she may not recommend an industry fund when it doesn't appear on the list. For example, HostPlus told the committee that 'product lists are a convenient way to lock us out'.[30] At a recent ASIC oversight hearing with the committee, ASIC commented that:

> ...the remuneration model at the moment often means that many financial advisers do not advise about industry funds. We are not making any secret of that.[31]

7.41 Where a large portion of the market is locked out of being distributed through the network of licensed advisers, there are potential implications for the quality of advice. Equipsuper indicated that recommending the best product is not always possible in the context of approved product lists:

> Most if not all financial planners work from an approved product list. In order to get onto the approved product list, the product must meet certain

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28 Fiducian Portfolio Services, *Submission 18*, p. 2.

29 Also referred to as platform fees this is a fee paid by product providers, in addition to commissions, to financial planning licensees to get their products on the approved product list.

30 Mr David Elia, CEO, HOSTPLUS, *Committee Hansard*, 6 March 2007, Melbourne, p. 59.

31 Mr Jeremy Cooper, Deputy Chairman, ASIC, *Committee Hansard*, 13 June 2006, Canberra, p. 13.

> criteria and go through a research process that says, 'Yes, this is an appropriate product for most of the people who will come to us.' Clearly, owning the body that creates the approved product list is a particularly useful way of ensuring that your own products achieve sales targets or are distributed widely. Certainly, you would like to think that financial planners will in all cases recommend the best product, but that may not be immediately apparent from the circumstances or the information that is provided. In most cases, the best that you could hope for is that the consumer will be recommended what appears to be the best product at that time and is appropriate for them. What is the best product is not always going to be entirely clear.[32]

7.42 Approved product lists also generate difficulties for clients seeking advice on choice of fund or consolidation where they hold an account with an industry fund. In accordance with the 'know your product' provision of the Corporations Act, advisers may not recommend a switch from one superannuation product to another without being able to assess the relative merits of both the existing fund and the recommended fund. Consequently, clients with an industry fund account are often told they cannot be advised on choice of fund as their potential 'from' fund is not on the adviser's approved product list.

7.43 Alternatively, if an adviser recommends a switch without knowing the features of the industry fund he or she is recommending a switch from, the act has been contravened. Speaking on the outcomes of its survey into superannuation advice at a recent oversight hearing, ASIC commented:

> Where you are recommending a switch, you need to look at the existing arrangements that the customer has and assess the plusses and minuses of moving out of that product and into a new product. You need to explain those to the client and then include them in the statement of advice. The report that you were referring to, the super switching report, had some rather unhappy outcomes. For example, people had existing funds, where they had quite reasonable insurance, and through lack of care on the part of the adviser it was recommended that they move into another product. They either lost that insurance or ended up having to pay much more for it. We set all that out in that report. That is really a summary of the legal obligation. It makes perfect sense. If you are giving professional advice to someone about whether they should move out of a fund, it is not rocket science to expect that you would have a look at what fund they are already in and see how it stacks up with what you are recommending. It is that simple.[33]

32 Mr Robin Burns, CEO, Equipsuper, *Committee Hansard*, 25 October 2006, Melbourne, p. 105.

33 Mr Jeremy Cooper, Deputy Chairman, ASIC, *Committee Hansard*, 13 June 2006, Canberra, p. 10.

7.44 Some respondents, though, defended individual advisers working within the parameters of their licensees' risk management structures. For instance, Rainmaker argued that:

> Financial planning provides a really valuable service and, like any service, it has to be delivered properly. We have to get rid of the conflicts of interest. But if planners are only allowed to talk about particular products because that is what they are licensed to talk about, then we cannot crucify them for talking about other products. What we should be doing is thinking about the regulation that is overrestricting them. Shadow shopping is fantastic, but I think to bag planners for doing what the law tells them to do is just silly.[34]

7.45 MLC argued that advisers were not recommending industry funds because they do not offer investment options other than superannuation:

> ...I do not think [advisers] are not choosing to use an industry fund because it does not pay commission; I think they are not choosing an industry fund because it does not offer, in many cases, all of those services they need to implement their advice. That might change over time. Industry funds might start to move into ordinary money and insurance. That might mean that they become more appropriate as a choice.[35]

7.46 Total Portfolio Management suggested that a lack of obtainable information often meant that advisers are not able to offer advice on industry funds:

> When seeking information from Industry Funds quite often the full extent of their fees are not shown. The actual management fees relating to the individual investments are not easily obtainable, and if we don't receive this information no advice can be given. Again the people who are being disadvantaged are those in the most need.[36]

7.47 Industry Funds Forum (IFF) rejected the argument that industry funds did not appear on approved product lists because critical information about them could not be accessed:

> I think that argument might have had some credence 10 years ago, but it has next to no validity now. There might be reasons why certain types of funds are not on a recommended list, but you cannot credibly say it is because we do not have access to information or we do not know where to obtain the information. That is just a nonsense.[37]

7.48 Treasury defended the basis for approved product lists:

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34 Mr Alex Dunnin, Executive Director Editorial and Research, Rainmaker Information, *Committee Hansard*, 24 October 2006, Sydney, p. 80.

35 Mr Steve Tucker, CEO, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 86.

36 Total Portfolio Management, *Submission 31*, p. 2.

37 Mr Ian Silk, Convenor, IFF, *Committee Hansard*, 25 October 2006, Melbourne, p. 127.

> The authorised product list is driven by the structure of the legal obligations that flow on to the licensee about giving advice. ... [W]e have said that the licensee has to be responsible for the advice given and has to be confident in the products that are being recommended. So there is certainly a very strong and valid argument on the side of industry advisers saying, ‘We need to be sure about the products that we are making recommendations for’.[38]

7.49 However, the department did indicate that the situation was being monitored:

> ...we are keeping a close eye on the way these things are done and the impact it is having on the marketplace and whether or not there are any distortions coming about as a result of the way products are being sold in the market.[39]

7.50 The payment of 'shelf fees' (in addition to commissions) to facilitate the placement of particular products on the list also received attention during the inquiry. In its April 2006 discussion paper on managing conflicts of interest in the financial services industry, ASIC indicated that licensees should avoid listing companies that pay shelf fees as it generated a conflict of interest, meaning that 'comparable or better' products that do not pay the fee are more likely to be excluded from the list.[40]

7.51 Choice told the committee of their concern over the apparent requirement to pay shelf fees to have products listed:

> ...we have become concerned about authorised lists becoming attached to platform fees. The product might make the authorised list because it has paid a platform fee. It might not make the list on its own merits but it might make the list because it has paid for the research to be done on the product—the various things that they have to do to change their computer systems to be able to list it. Our concern is that other products that are possibly good value and at lower cost to consumers are not making those lists.[41]

7.52 MLC told the committee that it does not pay shelf fees in order to avoid the perception of a conflict:

> ...whether or not shelf-space fees in reality introduce actual conflict, the perception must be that the reason why you are paying a shelf-space fee is

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38 Mr David Love, Manager Investment Protection Unit, Corporations and Financial Services Division, Treasury, *Committee Hansard*, 20 November 2006, p. 19.

39 Mr David Love, Manager Investment Protection Unit, Corporations and Financial Services Division, Treasury, *Committee Hansard*, 20 November 2006, p. 19.

40 ASIC, *Discussion Paper*, 'Managing conflicts of interest in the financial services industry', April 2006, p. 12.

41 Dr Nick Coates, Senior Policy Officer Superannuation and Financial Services, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 32.

> to get on the platform, and there must be a question about whether that biases towards that fund the underlying advice that is given.[42]

'Tied' advisers

7.53 The committee also heard concerns in relation to a lack of transparency over the relationship between advisers and superannuation product providers. In instances where advisers are licensed under the financial planning arm of a company that also distributes financial products, the distinction between the financial advice sector and the financial product sales sector can become blurred. Although consumers are aware of the sales motivations of the supplier's representative when visiting a car dealership, in the financial planning sector the incentives may not be as apparent to consumers where a financial services company integrates product supply and sales through its team of financial planners.

7.54 Presently, the nature of these relationships is not reflected in the labels, or nomenclature, attached to purveyors of financial advice. For instance, advisers are not required to describe themselves as an 'agent' or 'franchisee' where their status would be accurately reflected by these generally understood terms. Consequently, when consumers seeking advice on superannuation products try to identify a suitable financial adviser, the broad 'financial adviser' or 'financial planner' labels do not provide them with an instinctive feel for the adviser's motivations. Consumers in this sector are therefore less likely to be able to adequately filter conflicted advice.

7.55 Members Equity Bank highlighted the influence of the major banks in the superannuation product and advice market:

> During the course of the nineties all the major banks, rather than develop their own product offerings around superannuation ... acquired fund managers and superannuation providers. ANZ had a joint venture with ING, Westpac with BT and Rothschild, CBA with Colonial, NAB with MLC. So during the course of the nineties they acquired fund management and superannuation services. They then also acquired a large proportion of the financial planning networks, so they now have vertical integration from the advice through to the transactional banking capability, the banking relationship through to superannuation.[43]

7.56 It warned that many consumers would be unaware of the 'tied' relationship between certain advisers and products.[44]

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42 Mr Steve Tucker, CEO, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 88.

43 Mr Anthony Beck, Head Workplace Business, Members Equity Bank, *Committee Hansard*, 25 October 2006, Melbourne, p. 29.

44 Members Equity Bank, *Committee Hansard*, 25 October 2006, Melbourne, p. 30.

7.57 The Association of Financial Advisers (AFA) told the committee that disclosure in this regard is inadequate, as the owner of an adviser's licensee does not have to be disclosed.[45]

7.58 The committee notes ASIC's policy statement on managing conflicts of interest, which states that disclosures on the following will 'generally be appropriate':

> a) the extent (if any) to which the licensee (or any associated person) has a legal or beneficial interest in the financial products that are the subject of the financial product advice;
>
> b) the extent (if any) to which the licensee (or any associated person) is related to or associated with the issuer or provider of the financial products that are the subject of the financial product advice; and
>
> c) the extent (if any) to which the licensee (or any associated person) is likely to receive financial or other benefits depending on whether the advice is followed.[46]

7.59 AFA speculated that the tied adviser relationship is a product of the licensing of financial product providers, rather than individual advisers:

> ...part of the function of FSR has been that the majority of advisers are actually receiving remuneration from one source, although that source has a plethora of products. It would have been a better choice had they gone down the original line, which was individual licensing of advisers. We did not get that, so now we have to deal with what we have. I think it is a better situation than it has been previously, but in the AFA’s submission back in about 179 we said that the biggest fear we had was that we would go back to a tied adviser relationship, which meant the major distributors virtually corralling the advisers and which was what we went away from during the 170s—and it has happened.[47]

Remedies to improve the quality of advice

7.60 The present legislative arrangements to ensure that consumers receive an appropriate standard of advice are as follows. Firstly, section 945A of the Corporations Act stipulates that advice must be appropriate to the needs of the client having regard to his or her circumstances and knowing the subject matter being advised on. Secondly, advisers must manage conflicts of interest. The committee outlined the Corporations Act disclosure requirements with respect to conflicts of interest in Chapter 6.

7.61 ASIC has indicated that there is no prohibition on conflicts of interest when providing financial services, rather that they should be adequately managed through

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45 AFA, *Committee Hansard*, 20 November 2006, Canberra, p. 98.

46 ASIC, *Policy Statement 181*, 'Licensing: Managing conflicts of interest', August 2004, p. 19.

47 Mr Michael Murphy, Past President, AFA, *Committee Hansard*, 20 November 2006, Canberra, p. 98.

internal controls and disclosure. Where this is not sufficient the conflict must be avoided.[48] On the more specific issue of managing remuneration-based conflicts of interest, ASIC has indicated that while some conflicts can be managed through disclosure others should be avoided altogether:

> In some cases, disclosure to clients is an adequate mechanism for controlling conflicts of interest arising from remuneration practices. Part 7.7 of the Act generally approaches remuneration issues from a disclosure perspective (i.e. remuneration must be fully disclosed). However, licensees should consider whether any particular benefits, compensation or remuneration practices are inconsistent with the requirement to have adequate arrangements in place to manage conflicts of interest or with the requirement for the efficient, honest and fair provision of financial services. For example, those remuneration practices that place the interests of the licensee or its representatives in direct and significant conflict with those of the licensee's clients should be avoided (and not merely disclosed).[49]

7.62 In evidence to the committee ASIC stated:

> ...if a product manufacturer or an advisory network uses commissions as a form of remuneration then they need to be more cautious in managing the potential conflicts caused by those arrangements and in making sure that they do not undermine the integrity of the advice that is given. It is not an argument for or against commissions; it is simply to say that if you choose a particular business model that has in it a risk that is not inherent in another business model, the law obliges you to make a special effort to make sure that that business model does not cause any damage to the integrity of the advice which the law requires you to provide.[50]

7.63 The committee heard evidence, however, that the current mechanisms for managing conflicts of interest were not always sufficient to protect consumers from receiving an inadequate standard of advice. The results of ASIC's shadow shopping exercise lend credence to these concerns. The committee also notes that the introduction of Super Choice has exacerbated the possible deleterious effect of poor quality advice on superannuation. The following section examines possible remedies for addressing perceived deficiencies in the regulatory system to ensure fund members receive a high standard of superannuation advice.

Commissions and shelf fees

7.64 Instead of ensuring that consumers are fully aware of the conflicts of interest associated with commission-based remuneration for advice, some organisations advocated banning commissions on superannuation advice altogether. As justification

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48 ASIC, *Policy Statement 181*, 'Licensing: Managing conflicts of interest', August 2004, p. 11.

49 ASIC, *Policy Statement 181*, 'Licensing: Managing conflicts of interest', August 2004, pp. 14-15.

50 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 61.

for ending the practice, the compulsory nature of involvement in the superannuation system was regularly highlighted. For example, Members Equity Bank wrote in its submission:

> There can be no justification for consumers' superannuation guarantee charges being reduced by the imposition of a sales commission as the contribution is mandatory, paid by the employer, and is part of an employee's remuneration.[51]

7.65 The Australian Institute of Superannuation Trustees (AIST) was another organisation advocating the prohibition of commissions on superannuation contributions. It was particularly critical of commissions on compulsory SG payments:

> To allow a financial adviser or financial planner to reap a financial benefit via a trailing or one-off commission on an amount that must, by law, be paid into an employee's superannuation fund is unfair and unreasonable. (An adviser or sales agent does not have to work very hard to obtain funds that are legislated that an employee must receive.) Yet, the adviser or sales agent may be able to obtain a financial benefit from those contributions.[52]

7.66 In evidence to the committee it called for a total ban:

> We should not only go halfway; we should go all the way and get rid of commissions. It is outrageous that, on a nine per cent compulsory contribution, every Australian worker has to pay—that someone can sell someone that product and get a trailing commission on it. They did not have to actively go out and seek this. It is law. [53]

7.67 Industry Super Network also argued that commission-based remuneration should be banned entirely. It submitted:

> ...financial planners remunerated by commission suffer a direct conflict of interest and this has a deleterious effect on the quality of advice consumers receive from commission-remunerated planners.
>
> If commissions dominate the advisory industry, then products not paying commissions will rarely be recommended even if they are superior (indeed such products will not appear on the advisory firm's "approved product list"). Differential percentage commissions will inevitably encourage some advisors to favour high cost products even where they are inferior (the extreme example being Westpoint).[54]

7.68 However, it should be noted that Westpoint was not a superannuation product.

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51 Members Equity Bank, *Submission 64*, p. 4.

52 AIST, *Submission 79*, p. 15.

53 Ms Fiona Reynolds, Director, AIST, *Committee Hansard*, 25 October 2006, Melbourne, p. 91.

54 Industry Super Network, *Submission 77*, p. 6.

7.69 IFF argued that:

> ...customer-focussed financial advice and commission payments are not compatible with each other and the only way to ensure that appropriate financial advice is given, is to remove the temptation of commissions and soft dollar incentives in connection with financial advice.[55]

7.70 While still expressing their opposition to the practice, others adopted a more moderate stand. SuperRatings told the committee that commissions on mandated superannuation contributions should be phased out over a two to three year period.[56] Choice suggested to the committee that trailing commissions should either be banned or, at the very least, be more easily switched off when consumers are not receiving advice.[57]

7.71 Superpartners suggested that trailing commissions should be rebated where unaccompanied by the provision of advice:

> Pending regulatory change, [trailing] commissions so earned should be rebated to the affected members. Rebates should be recommended in ASIC guidance.[58]

7.72 IFF advocated forcing a shift through ensuring the complexity of maintaining commission structures:

> If the element of the mandated superannuation under advice was prohibited from having commissions applied against that, one would think that it would be a very complex model to charge in discretionary pieces for that advice. That would hopefully accelerate a move towards a more transparent fee-for-service across the whole gambit of money under advice.[59]

7.73 While acknowledging the limitations of commissions, MLC told the committee that a voluntary shift to a fee-for-service model is preferable to banning them altogether:

> We would like the industry to voluntarily move towards a fee model over time. We think it is more transparent, we think it is more in the interests of advisers because they will attract more customers and we also think it is better for the customers in terms of understanding how they are paying for the advice they are getting. We do not advocate any bans or changes to the regulations. We think the industry can move on this in a fairly short period of time to avoid the need for that, as any responsible industry should. It does take some time. The industry has been structured around commission

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55 IFF, *Submission 73*, p. 18.

56 SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 2.

57 Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 36.

58 Superpartners, *Submission 67*, p. 23.

59 Mr Paul Watson, Executive Committee Member, IFF, *Committee Hansard*, 25 October 2006, Melbourne, p. 128.

> for many, many years and it is very difficult for people to go home over the weekend and come back and change their business model.[60]

7.74 Contradicting these recommendations was the firmly held view among sections of the financial planning industry that commissions enable those who would not otherwise be able to afford financial advice to access it. The basis for support of commission-based remuneration is that it is preferable for people to have access to affordable yet conflicted advice, properly managed and disclosed, than to no advice at all. For instance, IFSA argued that:

> Commissions allow people to access advice and pay for it over time via their savings. Commissions also tie the interest of the consumer and the financial planner, and give an incentive for the planner to maximise a consumer's savings.
>
> Removing commissions from the remuneration mix will be to the detriment of middle to lower income consumers who cannot afford to pay the fee for service. IFSA believes that commissions are an important means of paying for advice, and any perceived conflicts of interest can be managed by disclosure.[61]

7.75 Similarly, in its submission to the committee FPA wrote that:

> ...if there is advice or some other service provided in relation to that money, it is legitimate for the provider of that service to be paid for that service. Any mandated move toward up front fee-for-service might disenfranchise lower income earners who simply cannot afford to pay for advice through an up front lump sum.[62]

7.76 However, Industry Super Network rejected the argument that eliminating commissions would exclude poorer clients from accessing advice. It raised the following three points:

- Firstly, there is no obligation for ongoing advice or service to be provided in order for the planner to earn the trail commission on an ongoing basis.
- Secondly, we do not accept that most Australians require detailed financial advice on superannuation. The average Australian has an account balance of $25,800. While they may need education and perhaps some limited assistance in relation to matters such as investment choice selection and maintaining appropriate insurance, a full scale financial plan (let alone ongoing advice for their entire working life) is unlikely to be justified. Claims made by the financial planning industry that the absence of ongoing advice will lead Australians to having insufficient superannuation to retire upon

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60 Mr Steve Tucker, CEO, MLC, *Committee Hansard*, 7 March 2007, Sydney, pp. 80-81.

61 IFSA, *Submission 60*, p. 17.

62 FPA, *Submission 38*, p. 6.

is self serving and not backed up by the 'net benefit' evidence already included in this submission.

- Finally, the consumers who are unable to pay upfront commissions would also be unlikely to be able to afford to have their retirement incomes eroded by trail commissions. A fee for service model provides a fair and transparent method of paying for advice which is less likely to erode a consumer's ultimate retirement benefits.[63]

7.77 IFSA rejected any interference from ASIC over the form of remuneration used, provided disclosure requirements are met. They maintained that a competitive financial services market would keep fees at reasonable levels:

> ASIC should ensure that it does not limit the remuneration methods available to both consumers and advisers. It is not for ASIC to determine whether commission or fee-for-service arrangements are the most appropriate form or remuneration. Indeed the current disclosure requirements in the law and the significant investment by both Government and industry in raising the standards and enhancing the regulation of financial advisers should not be undermined by the regulator. Instead, in a highly competitive and transparent market (driven by FSRA disclosure provisions on fees), competition should be the effective regulator on remuneration structures and payment levels.[64]

7.78 A number of contributors also drew on the significance of consumer choice when determining the methods of paying for advice that should be permitted. AXA commented that although FSR had raised the standard of advice, its cost had also increased. Consequently, clients should be entitled to choose how they pay for advice:

> More needs to be done to increase access to financial planning services, and at an earlier stage but undoubtedly one of the barriers to such access is the cost. During the earlier stages in life, when people are purchasing a house and starting a family, they have less disposable income and more competing demands for the money that could be spent on financial advice. Many individuals are reluctant to obtain financial advice because of the up front cost of doing so, and yet decisions made during these earlier stages in life can be critical to a family's future financial wellbeing.
>
> AXA supports the individual's right to choose how they pay for advice.[65]

7.79 The Association of Independent Retirees (AIR) expressed the view that commissions allowed consumers to test the market for advice without incurring great expense:

> We take the view that the marketplace should essentially determine those things. The reason for that is that quite a number of people when they are

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63 Industry Super Network, *Submission 77*, p. 10.

64 IFSA, *Submission 60*, p. 17.

65 AXA Asia Pacific Holdings Ltd, *Submission 45*, p. 7.

> about to retire or are retired want to get advice from a number of people. They do not want to pay a fee to every one of those people to get advice, so if they are going to pay an up-front fee they are almost locked into one person. But if they adopt the commission model, they can go to a number of people at no charge and they can then determine the best approach. So it is a bit of horses for courses. In our view, from the considerable experience of our members, it is better to leave that open because the providers of services will meet the market need. Some will operate on commissions and some will operate on fee for service.[66]

7.80 However, AIR did advocate a legislative prohibition on trailing commissions:

> They cause a lot of credibility problems and a lot of disenchantment, and there is no real rationale for them.[67]

7.81 ABA indicated that consumers should be able to choose in an environment in which fees were transparent:

> Whether a consumer chooses to pay commissions or fee-for-service should be at the discretion of the consumer, depending on what model suits their needs and financial situation. Therefore, it would be useful for there to be greater transparency around fee structures so that consumers can better understand fees and commissions and identify triggers that they may need to consider with respect to a particular investment.[68]

7.82 The committee earlier described the restrictions imposed on advisers by approved product lists, including evidence on the effect shelf fees may have on the likelihood of any given product making the list. One solution is to ban such fees being paid. ASIC has suggested that the conflict of interest generated by the practice should be avoided by platform providers not listing products that pay a shelf fee.[69]

7.83 AFA told the committee that shelf fees should be permitted, but they should be disclosed to clients:

> Our view is simple. It is around transparency, openness and disclosing to clients. In a sense it is a commercial piece of work and as long as people know what is going on and clients are fully informed about it then we are comfortable with that.[70]

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66 Dr James Ritchie, National Chairman Retirees Income Research Group, AIR, *Committee Hansard*, 20 November 2006, Canberra, p. 106.

67 Dr James Ritchie, National Chairman Retirees Income Research Group, AIR, *Committee Hansard*, 20 November 2006, Canberra, p. 106.

68 ABA, *Submission 88*, p. 14.

69 ASIC, *Discussion Paper*, 'Managing conflicts of interest in the financial services industry', April 2006, p. 12.

70 Mr Richard Klipin, CEO, AFA, *Committee Hansard*, 20 November 2006, Canberra, p. 89.

7.84 AFA indicated that presently only the remuneration being paid to the adviser needed to be disclosed, but this should be extended to fees paid by fund managers to licensed product providers.[71]

Committee view

7.85 The committee recognises the problems associated with commission-based remuneration. It generates conflicts of interest for advisers that in many cases lead to inappropriate advice, as demonstrated by ASIC through its shadow shopping survey. Furthermore, trailing commissions potentially lead to significant sums being paid to advisers throughout the life of a financial product without a commensurate return in the form of ongoing superannuation advice.

7.86 The industry funds sector argued most strongly for the prohibition of commissions for superannuation advice/product distribution, a position the committee can understand well. Most industry funds do not pay commissions and their products are generally not recommended by financial planners, for whom commissions form at least a significant proportion of their income. However, some industry funds do pay commissions, examples being Health Super and Statewide Super.

7.87 However, the committee does not recommend the prohibition of commissions on superannuation products. Many consumers cannot afford to pay for up front fee-for-service advice on their superannuation, especially with the unresolved problem of the current disclosure regime causing advice to cost more than its inherent value. The committee also acknowledges that the remuneration environment in which superannuation advice is provided is evolving. Super Choice has not been in existence for long and refinements to the regulatory framework have recently been implemented and more are proposed. According to ASIC, advice is increasingly being paid for through fee-for-service transactions and less through commission-based structures.[72]

7.88 Furthermore, banning commissions will not remove all potential conflicts of interest in the industry. Superannuation funds, including industry funds, have other remuneration practices such as bonuses and incentive plans for sales people which may give rise to conflicts.

7.89 The committee is therefore of the opinion that it would be premature to recommend the prohibition of commissions as recommended by industry funds. The financial planning industry appears to be shifting towards a fee-for-service model and superannuation funds themselves are moving to facilitate the use of member accounts to pay for up front advice. These are welcome trends. Given the weight of regulatory change in this area over the past two to three years it is reasonable for financial planners to be allowed to move away from commission-based remuneration models

71 AFA, *Committee Hansard*, 20 November 2006, Canberra, p. 89.

72 ASIC evidence at the committee's June 2006 oversight hearing, *Committee Hansard*, 13 June 2006, p. 23.

on a voluntary basis. Other strategies such as improving disclosure and education, mentioned later in this chapter, should also be given an opportunity to be implemented before prohibitive measures are taken.

7.90 The committee has more concern regarding shelf fees. Shelf fees can be anti-competitive and may encourage products to be listed and subsequently recommended that may not be in the best interests of the client. Unlike commission-based remuneration, shelf fees cannot be said to facilitate access to advice by making it more immediately affordable to those without discretionary funds to pay up-front fees.

7.91 On the other hand, it is argued that shelf fees result from the fact that the product platform incurs costs in putting a fund manager on an approved list. These include due diligence costs, information technology costs and publishing costs. There is also the risk that having put a particular fund manager on a platform, investors using the platform might not choose to invest in that particular product, so the shelf fee is the only means whereby the platform can recoup those costs.

7.92 There was no evidence before the committee that shelf fees have hindered consumer choice or reduced competition.

7.93 It is noteworthy that none of the major product platforms had Westpoint, Fincorp or ACR on their approved product lists. It therefore appears that the due diligence procedures undertaken in establishing approved product lists is effective.

7.94 Nevertheless, the committee has concerns about shelf fees. As the industry is progressively moving from commission-based to fee-based advice fees, so it should move from shelf fees to a more competitive means of meeting the cost of product listings. The ultimate ideal for the industry would be movement towards fees for advice, payment for funds management and payment for administrative services.

7.95 In the meantime, the Committee is of the view that the key issue is transparency and disclosure.

Recommendation 21

7.96 The Committee recommends that ASIC work with the industry to provide to investors more effective and detailed disclosure of shelf fees.

Better disclosure

7.97 The purpose of requiring commission-based conflicts of interest to be disclosed is to allow the client to reach their own determination as to the significance of the conflict and, in that light, the extent to which they will rely on the advice. However, the committee received evidence that the disclosure of conflicts of interest needs to be more effective to ensure consumers are better able to measure its likely affect on the quality of advice they receive.

7.98 FPA suggested that disclosure of fees and other critical information could be made more prominent for consumers:

> Clearly, we would like all of our advisers to be entirely professional and provide appropriate advice in the interests of the client. But if that is not going to be the case and we cannot completely control that, what are the warning signals from a client's point of view as well, and how do we provide information that sets warning bells going in the client's mind? We are talking, for example, about a five-point summary on top of a statement of advice, 'These are the things you must know.' Statements of advice can be 50 or 60 pages long. Does the client always understand that the commission is high? Do they always understand their particular risk profile and so forth? We are looking at putting some key risk, remuneration and service parameters on top of the statement of advice so that we can set the alarm bells going.[73]

7.99 Superpartners did not support banning trailing commissions or imposing a time frame beyond which they could not be paid. Instead, it also advocated improved disclosure:

> We have proposed a third solution, and that is a more targeted disclosure of the commission to members so that the member is informed that there is a commission payable for persistency rather than being misdescribed as a commission paid for advice.[74]

7.100 Count Financial Ltd highlighted the problem of providing reasonable advice on 'to' and 'from' funds that were differently structured and hard to compare. They suggested:

> To allow a fair and accurate comparison between a client's current super fund and a possible recommended super fund, we ask the Committee to consider recommending that a succinct client-specific comparison disclosure document be required to be produced by all super funds, in a format that allows for comparability.[75]

7.101 Another proposition put to witnesses was for different categories of advisers to be enshrined in legislation. This approach is founded on the view that effective disclosure is dependent on the label attached to financial advisers adequately reflecting their relationship with the products they subsequently recommend. For example, advisers could be licensed either as franchisees, agents or independent advisers utilising well-recognised labels to provide consumers with a more instinctive sense of the motivations behind the advice they receive.[76]

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73 Ms Jo-Anne Bloch, CEO, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 43.

74 Mr Paul Collins, Manager Legal Services, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 9.

75 Count Financial Ltd, *Submission 59*, p. 3.

76 See, for example, discussion with Ms Jo-Anne Bloch, Financial Planning Association of Australia, *Committee Hansard*, 24 October 2006, Sydney, p. 53.

7.102 Although advisers whose advice is 'tied' to the products sold by their employer are not currently permitted to describe themselves as 'independent', they do not have to qualify their advertised 'financial adviser' status by using prescribed nomenclature such as 'agent' or 'franchisee'.

7.103 Treasury, though, told the committee that the legislative codification of this approach had not worked in the United Kingdom:

> They basically polarised it into two extremes: you had the pure product sales advice where you could only deal with your own product provider's product line, so you were really like a salesman, and then you had the people who were completely independent and offered a whole range of things.
>
> They found it extraordinarily difficult to make that work in the UK and they have had to move back from it into a situation that is much closer to the idea of authorising product lines that occurs here.[77]

7.104 However the committee notes the apparent inconsistency of this position when held against the government's proposed legislative changes described below.

7.105 ASIC stated that the law already restricts advisers from the labels they may attach to themselves:

> ...the law already provides that a person may not call themselves independent unless that is in fact true. So we do not need to create a new category of independent adviser, because the law already does that. A person is not entitled to call themselves an independent adviser unless that is actually factually true in every respect.[78]

Recent initiatives

7.106 The committee notes two initiatives that reflect an attempt to improve the efficacy of disclosure in this area. From a regulatory perspective, in November 2006 the government released a proposals paper on corporate and financial services regulatory reform. These proposals were to be incorporated into the Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007 that was introduced into the parliament on 24 May 2007.[79]

7.107 One of the proposals was to enable financial product sales recommendations to be made without triggering personal advice disclosure requirements. Referring to the common scenario whereby agents of financial product issuers, solely responsible

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77 Mr David Love, Manager Investment Protection Unit, Corporations and Financial Services Division, Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 16.

78 Mr Malcolm Rodgers, Executive Director Regulation, ASIC, *Committee Hansard*, 20 November 2006, Canberra, p. 64.

79 Treasury, *Corporate and Financial Services Regulation Review: Proposals Paper*, November 2006.

for selling products, are required to meet the SoA requirements triggered by the provision of personal advice, the proposals paper stated:

> In those situations, it may not be appropriate for that client to be under the impression that they are being given (and possibly charged for) advice. It may also not be appropriate for the agent to be purporting to provide advice or to be regulated as a financial adviser.
>
> The issues that arise in such transactions are whether the role of the service provider and the nature of the service being provided is transparent to, and understood by, the consumer, and whether such salespeople should be presented and/or regulated as though they are providing advice.[80]

7.108 The paper outlined the proposed new category of financial service, separate to financial product advice, as follows:

> It is proposed to provide that, in certain situations, financial product providers and their representatives would be able to recommend financial products based on a client's objectives, financial situation and needs without that recommendation constituting financial advice (either personal or general). Under the proposal, this would be defined as a financial product sales recommendation (sales recommendation).
>
> A sales recommendation may contain elements of personal and/or general advice and would still be a form of financial service, but it would not be captured by the personal and general advice definitions. Persons permitted to provide sales recommendations would only be able to sell financial products for issuers that they act on behalf of. They would not be able to also deal in financial products where they do not act on behalf of the relevant issuer. The sales recommendation definition would be subject to its own regulatory requirements.[81]

7.109 The disclosure requirements associated with this category of financial service would be contained in a 'Sales Recommendation Warning' that could form part of the Financial Services Guide (FSG). This would include information on which entity they are acting for, as well as commission payments and related conflicts of interest.[82] In addition, individuals would not be authorised to provide both licensed financial advice *and* sales recommendations, which Treasury described as 'ring-fenc[ing] a sales recommendation service to ensure that it is separate from the financial advice stream'.[83]

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80 Treasury, *Corporate and Financial Services Regulation Review: Proposals Paper*, November 2006, p. 14.

81 Treasury, *Corporate and Financial Services Regulation Review: Proposals Paper*, November 2006, p. 15.

82 Treasury, *Corporate and Financial Services Regulation Review: Proposals Paper*, November 2006, pp. 17-18.

83 Treasury, *Corporate and Financial Services Regulation Review: Proposals Paper*, November 2006, p. 22.

7.110 Treasury told the committee that the government's intention was to better enable clients to recognise instances where the advice they are receiving is driven by a sales motivation:

> ...the government has come forth with the proposal in regard to sales recommendations, which is aimed at making much more transparent and distinguishing more clearly for consumers the relationship between a provider of a product and those who are giving, let us say, more disinterested client focused advice.
>
> ...
>
> ...we want to make as transparent as possible for consumers the relationship between the seller, or the person holding themselves out to give advice, and the product provider. We feel that this is the real difficulty. For example, if you are buying a car and you walk into a Holden dealer, you know that there is a clear relationship there and you assume that there are commissions being paid, even if you do not know the details. That relationship is very transparent and consumers understand it quite intuitively. At the moment, the way the personal advice model is set up, in many cases it appears to the consumer that they have an adviser who has only their interests at heart. We are saying that we think it is desirable to have a much clearer delineation between those two situations...[84]

7.111 However, the applicability of this proposal to the provision of superannuation advice/product sales was unclear. Despite Treasury's statements to the committee, the proposals paper indicated that the sales recommendation framework would not apply to a superannuation product or retirement savings account.[85] When the bill was introduced into the parliament the proposal had not been included.

7.112 Turning to the realm of industry self-regulation, in January 2005 FPA released a paper providing information to its members on managing conflicts of interest in the financial planning sector. FPA told the committee that its conflict of interest principles are based on disclosing to clients the way commissions operate:

> ...our conflict of interest principles require that the commission be split between advice and product so that you can see which component goes to advice and which bit goes to product, and our conflict of interest principles also require that the remuneration does not bias the advice that is given, and that in fact the advice and necessarily the implementation of advice is in the interests of the client. I think that is a legislative requirement, anyway. It is not that we have come up with some revolution here. We are just demanding of our members that these things are put on the table and the clients absolutely understand what it is they are paying for. [86]

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84 Mr David Love, Manager Investment Protection Unit, Corporations and Financial Services Division, Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 17.

85 Treasury, *Corporate and Financial Services Regulation Review: Proposals Paper*, November 2006, p. 17.

86 Ms Jo-Anne Bloch, CEO, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 38.

Potential effect of disclosure

7.113 Despite these initiatives from government and the industry, many contributors to the inquiry strongly maintained that disclosure of commission-based conflicts of interest does not offer sufficient consumer protection from poor advice, particularly given poor financial literacy across the community. Choice was one such organisation to argue this position:

> ...the research that we have seen on declaring commissions shows that it has the perverse effect. How does a consumer discount, for example, a four per cent commission and a three per cent commission? How do they discount the value of the advice on the basis of that commission? It is very difficult for them to do that. When the commission is disclosed, the behavioural finance research is that they trust the adviser more because they feel that they have been told a secret. The other side of it is that the adviser then thinks that their advice is objective because they have disclosed the commission to the consumer, so it can have a perverse effect.[87]

7.114 Industry Super Network also highlighted widespread financial illiteracy when commenting on the inadequacy of disclosure in this context:

> ...in no other professional relationship is such a conflict permitted to exist. The planning industry generally holds up disclosure as an answer to the problem of commissions; however, we think it is a grossly inadequate solution. We do not believe that the average consumer fully appreciates the compounding effect of higher fees and commissions, which significantly erodes retirement savings over a working life.
>
> What should be done? We submit that a legal requirement for financial advisers to act in their clients' best interests is required.[88]

7.115 Superpartners raised concerns over 'certain industry practices where disclosure of commissions may not be adequate'. These were nominated as:

(a) commission paid for procurement of members;

(b) trail commission misdescribed as ongoing service commission; and

(c) commission paid by an interposed entity.[89]

7.116 Fiducian Portfolio Services, however, criticised the focus on disclosing the cost of fees, rather than ensuring clients received the value of advice:

> Even superannuation Product Disclosure Statements are prescribed to display a "Warning" that a lower fee can result in a higher saving. We believe that it is derogatory to have to present fees with a "Warning" sign

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87 Dr Nick Coates, Senior Policy Officer Superannuation and Financial Services, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 32.

88 Mr Gary Weaven, Spokesperson, Industry Super Network, *Committee Hansard*, 6 March 2007, Melbourne, p. 17.

89 Superpartners, *Submission 67*, p. 21.

akin to a cigarette packet that has connotations of death. As a consequence, investors could probably divert their funds to a product that could be 0.1% or 0.2% cheaper, but not realised that they could have earned 3% to 5% more on their assets through careful financial planning, risk profiling and product Election, They might have saved $10,000 to $15,000 on their fees over a lifetime, but ended up hundreds of thousands of dollars worse off.[90]

7.117 IFSA maintained that disclosure is sufficient and expressed concern that ASIC was targeting businesses that integrated financial product supply and sales:

> The Discussion Paper released by ASIC in April 2006 entitled MANAGING CONFLICTS OF INTEREST IN THE FINANCIAL SERVICES SECTOR gave rise to a significant level of concern amongst industry participants.
>
> ...
>
> The ASIC Discussion Paper appeared to express a bias particularly against conglomerate arrangements and institutional ownership of advisor groups. The fact is that many customers prefer to obtain advice from an adviser who is backed by the financial strength and security of a large financial institution and to invest through a product from the parent institution as long as it is clearly disclosed and they receive choice and appropriate advice regarding their underlying investment and insurance options.[91]

Mandating a higher standard of advice

7.118 The regulatory standard stipulating the quality of financial advice is that it meets the threshold of appropriateness for the client. IFF told the committee that it should be higher:

> We ... believe that financial planners should have a legislative obligation to act in the best interests of their clients. Many planners do that now, but we cannot think of a good reason why there should not be mandatory obligation on all planners to do so.[92]

7.119 However, in the context of approved product lists IFSA stated:

> The regulator has raised the question as to whether the [approved products and services list] APSL may prevent a planner meeting the reasonable basis of advice obligations, particularly when switching advice is given. IFSA believes that the law requires a planner to ensure that any product recommendation that is made must be appropriate for the client. The planner is not required to recommend the best product in the market.
>
> Therefore, as long as the products on the planner's APSL contains products that are appropriate to meet their client's needs (regardless whether they are

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90 Fiducian Portfolio Services, *Submission 18*, pp. 2-3.

91 IFSA, *Submission 60*, p. 19.

92 Mr Ian Silk, Convenor, IFF, *Committee Hansard*, 25 October 2006, Melbourne, p. 118.

in-house products), then a restricted APSL should not prevent a planner meeting their reasonable basis obligations. The law requires planners to recommend appropriate, not best products.[93]

Facilitating affordable fee-for-service advice

7.120 With poor quality advice on superannuation being widely attributed to the conflicts of interest inherent with commission-based remuneration, many contributors to the inquiry focused on the importance of facilitating the provision of fee-for-service advice. There was uncertainty though over the extent to which the sole purpose test under section 62 of the SIS Act constrained the use of superannuation accounts to pay for up-front financial advice.

7.121 RCSA and PASL advocated a clarification of the sole purpose test to facilitate remunerating financial advisers from a member's account:

> At present it appears that the Sole Purpose Test may present a barrier to using money from accounts to pay for advice. We believe this situation should be clarified and argue that this method of payment is preferable to the alternative situation where a fund provides free financial advice to members.[94]

7.122 A number of organisations argued that the scope of the sole purpose test is too narrow in this context, restricting members from using their accounts to pay for advice not specifically related to superannuation that will nonetheless maximise their overall retirement income. For example, IFF noted the limitations on the provision of beneficial financial advice imposed by the sole purpose test:

> Currently there is very limited scope for use of retirement savings to fund financial advice. This is due to the constraints imposed by the sole purpose test under Section 62 of SIS. This limits use of superannuation funds to advice concerning the superannuation product a member has invested in and superannuation advice generally. This prevents members using retirement savings to fund financial advice on their overall financial position, which requires consideration of what other assets they have at their disposal.[95]

7.123 Equipsuper told the committee:

> If a member approaches a financial planner seeking advice on retirement planning, the planner is required to consider both the member’s superannuation and non-superannuation assets. However, superannuation funds are currently permitted to deduct from the member’s account only the

93 IFSA, *Submission 60*, p. 18.

94 RCSA and PASL, *Submission 56*, p. 7. See also MLC Ltd, *Submission 83*, p. 12.

95 IFF, *Submission 73*, p. 19.

> cost of that part of the advice which relates to superannuation affairs, which clearly complicates the whole process.[96]

7.124 MLC suggested that:

> It will divert money out of the superannuation account in the short term, but it is recognising that somebody's holistic affairs revolve around more than just superannuation. A significant impact to their retirement outcome could be had by dealing with advice around cash flow issues or advice around how they structure their debt—with regard to the amalgamation of debt, with regard to gearing, and with regard to investing in moneys outside superannuation. So we suggest that thinking about protection of superannuation to the extent of 'We will not take fees out of that to help us to pay for advice on the whole lot' might slightly impact on their superannuation outcome but the advice, when taken in its totality, might have a huge impact on them.[97]

7.125 Sunsuper recommended allowing for the provision of broader financial advice funded by superannuation savings, with appropriate limits. It submitted:

> The main barrier to seeking advice for many of these people is access to appropriate and affordable advice.
>
> ...
>
> Allowing members to access a small amount of their superannuation savings to fund appropriate retirement advice can overcome this barrier to some extent. However, the sole purpose test under Section 62 of SIS limits the use of superannuation funds to advice concerning the superannuation product a member has invested in and superannuation advice generally. This prevents members funding advice on their overall financial position from their superannuation account.
>
> We support access to superannuation savings to fund financial advice relating to retirement, however we acknowledge there must be appropriate protections on this to ensure it is not subject to abuse. The types of protection would include:
>
> - An annual cap on the amount withdrawn from the account in the order of a few hundred dollars
> - Adviser remuneration on a true 'fee for service' basis only
> - Advice provided only by advisers approved by the trustee.
>
> We also support improved clarity on the sole purpose test under Section 62 of SIS regarding the use of superannuation savings to fund financial advice.[98]

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96 Mr Robin Burns, CEO, Equipsuper, *Committee Hansard*, 25 October 2006, Melbourne, p. 102.

97 Mr Steve Tucker, CEO, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 83.

98 Sunsuper, *Submission 74*, pp. 10-11.

7.126 Members Equity Bank offered a broad interpretation of the sole purpose test:

> ...we would take the view that traumatic events that interrupt their employment, their earning capability and their ability to contribute to super are matters that bear more directly than indirectly upon the members' end benefits.[99]

7.127 AIST also stated that a broader interpretation of the sole purpose test would be of net benefit to consumers:

> ...there is quite a strong correlation between employment, superannuation and the benefits of having salary continuance insurance or death and disability insurance. If you cannot work, you then do not get super. That is where the insurance and those sorts of benefits kick in. ... On the proposition that insurance should be excluded from coming out of the superannuation accounts because it reduces the retirement income, we would firmly put the view that the benefits of things like insurance and salary continuance to ordinary Australians, and every Australian that has superannuation, far outweigh the reduction of that retirement benefit.[100]

7.128 IFF offered cautious support for a loosening of the restrictions imposed by the sole purpose test in this area:

> This practice needs to be properly controlled and addressed in the legislation to ensure that use of superannuation savings for this purpose is not subject to abuse. This would include:
>
> - a blanket prohibition on commission being earned from advice funded in this way;
> - a requirement that the advice be in the best interests of the member ; and
> - the type of financial advice that can be given on this basis (i.e. confined to advice on superannuation issues).

7.129 It added:

> The industry needs greater clarity about what superannuation funds are able to do in this area, so there is a consistent approach and so members are aware they can fund access to financial advice in this way.[101]

Altering the effect of trailing commissions

7.130 Other proposals attempted to address the problem of ongoing trailing commissions not matched by the provision of advice, a problem identified earlier in

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99 Mr Anthony Beck, Head Workplace Business, Members Equity Bank, *Committee Hansard*, 25 October 2006, Melbourne, p. 32.

100 Ms Susan Ryan, President, Board of Directors, AIST, *Committee Hansard*, 25 October 2006, Melbourne, p. 95.

101 IFF, *Submission 73*, pp. 18-19.

the chapter. Suggestions focused primarily on enabling consumers to trigger commission payments when they actually receive advice, rather than expecting them to take positive measures to 'turn off' the commission upon realising they are not receiving the benefit of advice.

7.131 SuperRatings suggested that payments for advice should be based on the principle that clients should be able to opt in to the charge, rather than opt out when they realise they are not getting the advice they are paying for. It said: 'the cost of that advice component or services component needs to be stripped out of those fees and then the member applies for advice'.[102]

7.132 IFF cautiously expressed its preference for dial up fees:

> It is certainly a better model to dial up than to dial down. There would need to be a lot of consideration given to the actual operation of that model. Whilst it is theoretically a better model, if it operates de facto as a dial-down situation in the privacy of an adviser-client discussion, then of course that does not progress it very far at all. The notion of the product having a cost or a fee attached to it and then, quite separately, a cost or fee attached to the provision of advice is a good model.[103]

7.133 Choice also suggested that dial up is preferable, but not ideal:

> In an ideal world we would not need to have the remuneration structure attached to product recommendation. But if we were going to talk about a commission, then probably dial up gives the consumer more market power. That having been said, you might only need a relatively small amount of advice and the adviser, to be able to expand their dial-up commission, starts to throw in all the bells and whistles he possibly can to expand the size of that commission.[104]

Committee view

7.134 The disclosure of conflicts of interest caused by commission-based remuneration arrangements is critical. However disclosure must be effective and meaningful, rather than a perfunctory process simply undertaken to comply with legislative requirements. The regulatory framework for disclosure should ensure that consumers comprehend the nature of the material being disclosed. Ideally, clients should be able to interpret the advice they have received in the context of the remunerative motivations of their adviser. In other words, he or she should be in an informed position to answer the question: is this advice conflicted to the extent that an alternative source of advice should be sought?

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102 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 15.

103 Mr Ian Silk, Convenor, IFF, *Committee Hansard*, 25 October 2006, Melbourne, p. 123.

104 Dr Nick Coates, Senior Policy Officer Superannuation and Financial Services, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 37.

7.135 As with product disclosure statements, statements of advice should display critical 'warning bell' information prominently. The committee supports FPA's voluntary endeavours to improve industry practice in this regard and urges it to use its authority to ensure that practical improvements are achieved. This is preferable to using the blunt instrument of mandating standard SoAs by regulatory means. The committee also notes that education is relevant to improving the effectiveness of disclosure, an issue discussed later in this section.

7.136 The proposal to raise the threshold of the standard of financial product advice from 'appropriate' to 'best' is not supported by the committee. Although it is preferable that clients are given the best advice possible, the reality of providing financial advice within the constraints imposed by approved product lists render this an unobtainable objective. Advisers on superannuation products cannot offer that which does not appear on the list authorised by their licensee, which in the opinion of the committee is a reasonable risk management tool to use.

7.137 Therefore the committee is of the view that instead of changing the legislative threshold for the standard of advice, the less conflicted fee-for-service remuneration model should be encouraged and consumers should be better equipped to interpret the advice they receive. The committee deals with the latter approach in its comments on disclosure above and education and financial literacy below.

7.138 The committee was told that although some superannuation funds are increasingly implementing the framework to allow payments for up front advice from member accounts, uncertainty as to the legal constraints on such measures was also prevalent. The sole purpose test seems straightforward in this context, clearly stipulating that superannuation account funds may only be used to pay for advice on superannuation. However the breadth of what constitutes advice on superannuation is contestable. For instance, does advice not directly related to superannuation assets but to maximising retirement income more broadly accord with the sole purpose test? Undoubtedly, professional advice on managing non-superannuation assets can affect the amount of money a person is able to contribute to superannuation.

7.139 Given the level of uncertainty over the scope of the sole purpose test in this context, the committee is of the opinion that detailed guidance for the industry on this matter would be beneficial.

7.140 The committee would further support an interpretation that is less restrictive than it appears to be at present. Caution should be exercised in this regard, though. Superannuation funds should not be permitted to be used to pay for all types of financial advice, which would leave the system open to abuse. The purpose of superannuation is to provide an income stream for retirees and the advice that it pays for should be directed to that purpose. Accordingly, the committee is of the view that limitations would need to be applied to any loosening of the constraints currently imposed by the sole purpose test. Limitations that ought to be considered would include applying a cap on the amount that could be withdrawn to pay for advice, prohibiting advisers from earning commissions on advice paid for through this

mechanism and ensuring a connection between the advice and long term financial objectives.

7.141 The committee is therefore of the opinion that, in consultation with the superannuation industry, the government should refine the application of the sole purpose test to allow the payment of up front financial advice from superannuation accounts.

Recommendation 22

7.142 The committee recommends that the government consult with the superannuation industry with a view to reducing, with appropriate limitations, the constraints imposed by the sole purpose test on the payment of up front fees for financial advice from superannuation accounts.

7.143 The committee also notes the suggestion to nullify the effects of trailing commissions by implementing a system whereby clients needed to opt in to paying commissions for superannuation product advice as opposed to having to opt out. This puts the onus on advisers to request that the commission be dialled up, rather than expecting consumers to take positive action to have the commission turned off, or 'dialled down', when the fee is not complemented by the provision of advice. The effect would be to better alert consumers to the nature of the charge and encourage them to consider its merit.

7.144 Unfortunately, it is difficult to contemplate how such an arrangement could be mandated without being manipulated by advisers to enable them to receive the same level of commission anyway. As Choice told the committee, clients could be easily convinced that they require 'bells and whistles' to justify paying commission for services they do not particularly need. While the practice ought to be encouraged on the basis that it could assist in separating the superannuation product sales and advice components of commission payments, the committee believes that the objective for the government and the industry should be to phase out the practice entirely.

7.145 Finally, the committee is concerned about insufficient transparency with regard to the relationship between advisers, their licensees and superannuation product providers. It is apparent clients may not be aware of the integration of superannuation product supply and sales advice and the incentives that stem from such an arrangement. The committee is of the opinion that disclosure will not be effective unless the nomenclature attached to financial advisers accurately conveys to consumers the adviser's relationship with, and interest in, the superannuation products they recommend. Accordingly, the government should investigate the most effective way to prescribe appropriate nomenclature where the product recommendation advice available to consumers is limited by sales imperatives.

Recommendation 23

7.146 The committee recommends that the government investigate the most effective way to develop with the industry appropriate nomenclature where the product recommendation advice available to consumers is limited by sales imperatives.

7.147 The committee is also of the view that financial advisers should be required to disclose to their clients the ownership structure of the licensee under which he or she is operating.

Recommendation 24

7.148 The committee recommends that ASIC should release a policy statement mandating that financial advisers disclose the ownership structure of their licensee when making a superannuation product recommendation.

Education and financial literacy

7.149 A major theme throughout the inquiry was the importance of arming consumers with the skills to interpret the quality and independence of the advice they receive. For instance, Superpartners summed up the vulnerability of consumers when it stated: 'A lot of members do not have the level of financial literacy required to even accept advice'.[105] Members' Equity Bank argued that low levels of financial literacy, combined with a choice of fund regime, had created a 'high risk environment' for consumers.[106]

7.150 AFA espoused education as the long term solution to consumers making informed decisions about advice on superannuation:

> Disclosure is key and critical, but the longer term solution is education. You have seen pretty much all of the mainstream press—television shows, websites and so on—driving education to consumers. The literacy foundation is another key part. If we start education about finances when our kids are in school, we will be better positioned to make informed decisions as we get to our 20s and so on. Obviously, because superannuation for all has only come in in the last 15 to 20 years, we have to grow people through that process. They now face key and important decisions about big amounts of money. There are practice based things and then there are broader industry things that can happen.[107]

7.151 As described in the previous chapter, superannuation funds have complained that FSR has prevented them from providing educational material to members. Some

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105 Mr Frank Gullone, CEO, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 4.

106 Mr Anthony Beck, Head Workplace Business, Members' Equity Bank, *Committee Hansard*, 25 October 2006, Melbourne, p. 27.

107 Mr Richard Klipin, CEO, AFA, *Committee Hansard*, 20 November 2006, p. 97.

funds argued that the FSR restrictions on targeted educational material had fostered a conservative approach to educating members about their options, denying them an important source of information.[108] Criticism was also levelled at the regulation of providing mechanisms to calculate projected benefits, which assist members in determining appropriate contribution levels to meet future retirement income needs.[109]

7.152 However notwithstanding the impediments created by FSR, ASFA explained that education at the fund level is still difficult in the face of widespread apathy:

> Large funds use a variety of communication methods. There are mass mail-outs. They are big customers of Australia Post. Much of that information gets binned. It is just the nature of it. It is a turn-off for some people.[110]

7.153 The financial advice industry also highlighted their educative role, telling the committee that access to professional advice is an important element in assisting consumers to become financially literate. For example, FPA told the committee:

> ...the role of the financial planner is very much to provide an ongoing education process. You cannot teach somebody everything all at once, but as part of an ongoing relationship they develop more and more understanding of risk and return.[111]

7.154 AFA told the committee their role is to educate 'vulnerable' clients:

> I tend to think that most of my clients when they come to see me are financially illiterate. Therefore, it is our role to educate them about what is available, what we expect of them in managing their financial affairs, what their goals and objectives are and what their risk profile is. That is part of our education process; that is what we get paid to do: to help them. I agree with you that they are in a very vulnerable situation.[112]

7.155 IFSA stated that advisers were needed to complement the government's literacy initiatives:

> There needs to be a recognition that the industry in advice in Australia is fundamentally sound and that sustained criticism of the advice industry runs counter to recent government attempts to improve financial literacy and financial understanding.[113]

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108 See for example REST, *Committee Hansard*, 24 October 2006, Sydney, pp. 57 and 64.

109 See for example Corporate Superannuation Association, *Committee Hansard*, 5 March 2007, Melbourne, pp. 30 and 32.

110 Mr Ross Clare, Principal Researcher, ASFA, *Committee Hansard*, 24 October 2006, Sydney, p. 33.

111 Ms Glenese Keavney, Superannuation Committee Member, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 46.

112 Mr Dennis Bateman, National President, AFA, *Committee Hansard*, 20 November 2006, p. 96.

113 Mr Richard Gilbert, CEO, IFSA, *Committee Hansard*, 24 October 2006, Sydney, p. 90.

7.156 Previous discussions in this report related to the advisers' view that they are an important element in improving financial literacy. In Chapter 6 the committee explored the difficulty of accessing affordable professional financial advice due to onerous disclosure requirements. The remuneration debate outlined above is also relevant, with some contributors arguing that commission-based fees improve the likelihood of consumers affording educative guidance on superannuation from their financial adviser.

7.157 There are two distinct elements to this debate. One, as correctly identified by advisers and funds in the context of their own educative role, relates to understanding the choices available within the system. The other relates to understanding how the system works, allowing consumers to make informed decisions about the quality of the information they are exposed to. While advisers can provide useful guidance on superannuation, the proposition that advisers can bestow consumers with the understanding to better interpret financial advice is problematic. Such a role is best left to government-led initiatives.

7.158 In this respect, the federal government has introduced measures aimed at improving financial literacy standards. On 6 June 2006, the government launched the Financial Literacy Foundation, which includes the following initiatives:

- a media campaign and website titled 'Understanding Money', designed to raise awareness of, and provide information on, financial literacy;
- working with state and territory governments to include financial literacy in the curriculum for Years 3, 5, 7 and 9 from 2008;
- working with employers to improve access to financial literacy information;
- undertaking research to establish a benchmark for national financial literacy and ascertaining the most effective way to deliver information to consumers;
- establishing a web-based catalogue of financial literacy resources.[114]

7.159 With a more specific focus on consumer protection in the financial services market, ASIC has also developed an education-based website, titled FIDO. It provides a broad range of information on the superannuation system, superannuation products and seeking financial advice.[115]

7.160 However SuperRatings told the committee that even more funding for education is needed:

114 Treasury, *Understanding Money website*, http://www.understandingmoney.gov.au/Content/Consumer/aboutUs.aspx, (accessed 1 May 2007).

115 ASIC, *FIDO website*, http://www.fido.asic.gov.au/fido/fido.nsf, (accessed 1 May 2007).

> There is still a significant level of apathy among Australians with regard to superannuation. Given that it is there to fund Australians' retirement income in the future, the education level needs to be stepped up. Following on from that, the financial literacy board that the government has put in place appears to be underfunded and more should be done with regard to that.[116]

7.161 It also emphasised the importance of improving broad financial literacy before attempting to resolve some of the more technical issues related to choosing appropriate investment or insurance strategies:

> I think those things are thrown up too often before we have even sorted the macro position, which is that Australians do not care about super.[117]

7.162 Superpartners suggested that standard, simple terminology was an important aspect of the education process:

> ...there are plenty of opportunities for us to standardise the way things operate around superannuation funds, thereby acclimatising members to one terminology and the processes that are used to access or get out of a fund. That takes a layer of cost out of it and simplifies the process. It is a bit like a tax return. If we all had different tax return forms, given our circumstances, it would make it a very complex environment. I think there is plenty of opportunity for us to standardise and simplify elements of our superannuation system.[118]

7.163 In addition to the provision of educational information on superannuation, ASFA suggested that facilitating an alternative disciplinary framework for fund members to make decisions in was also important. It advocated a form of 'soft compulsion' utilising a triggering event such as changing employers to automatically increase an employee's post-tax contribution, but allowing that person to opt out should they so desire. ASFA said:

> Education is a very important element. The research has been done overseas and, when we look at international examples, education is just one plank. In fact the idea of having a structure and discipline which people work within is also very important. So one of the very important things is changing people's awareness that nine per cent is not quite enough. At the moment people think nine per cent SG: that is what the government thinks, therefore that must be enough. We need to change the norm more from nine per cent to 12 per cent. The idea of the soft compulsion or having a structure which is not compulsory or obligatory does two things. It says that the norm

116 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 3.

117 Mr Jeff Bresnahan, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 13.

118 Mr Frank Gullone, CEO, Superpartners, *Committee Hansard*, 25 October 2006, Melbourne, p. 10.

> should really be 12 per cent and it also provides a structure which provides an easy discipline for people to work within.[119]

Committee view

7.164 The shift from passive superannuation investments in which employers bore investment risk, to today's competitive market in superannuation products where investment risk has transferred to employees, has left consumers more vulnerable to the vagaries of the marketplace than they previously were. This transfer of risk has left superannuation fund members with the responsibility for taking a number of decisions that were previously not required of them. As such, measures need to be taken to enable consumers to adapt to their acquired responsibility.

7.165 The committee firstly recognises that the provision of information from the superannuation industry to its clients has an important educative role. Government initiatives can stimulate people's interest on the subject and provide generic material on the system and interpretive information and advice, but the funds and advisers usually have a more direct input into educating consumers on their own superannuation arrangements. Thus it is important that the government clarify what information provided by superannuation funds represents personal financial advice under the Corporations Act.

7.166 Many of the problems with the provision of superannuation advice identified in this report are a consequence of consumers not having the knowledge to interpret the information they receive and the motivations of those that have provided it. Consequently, education is critical to improving the effectiveness of disclosure. If consumers were more financially literate then conflicted advice thus disclosed could be more meaningfully interpreted and superannuation products paying ongoing trailing commissions could be eschewed. Clients would be more cognisant of the relationship between their adviser and the products they recommend and they would be in a much more secure position from which to exercise their choice of fund options.

7.167 The committee recognises the difficulty of the task. Measurably improving overall financial literacy is not an undertaking that will yield results in the short term. Many Australians with money in superannuation do not take an active interest in superannuation issues, making education campaigns problematic in terms of their effectiveness. The committee believes this challenge can effectively be addressed by improving the accessibility of advice for those already in the system, from funds and licensed financial advisers, as well as ensuring that future superannuation fund members are provided with appropriate guidance during their school years.

7.168 The committee notes with approval the government's Better Super television and radio advertisements designed to inform and educate people about the reforms to superannuation which came into effect on 1 July 2007.[120]

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119 Ms Philippa Smith, CEO, ASFA, *Committee Hansard*, 24 October 2006, Sydney, p. 30.

7.169 The committee also supports the government's Financial Literacy Foundation initiatives. However it is important that the initiatives be actively monitored to ensure that resources are spent wisely. In addition, programs that are designed to bring progress in this area should be provided with additional funding if so needed. Consumers are in an increasingly vulnerable position with respect to their superannuation investment and consequently deserve to be provided with the tools to manage the risks they now shoulder.

Recommendation 25

7.170 The committee recommends that the government conduct a review of its Financial Literacy Foundation initiatives when their effectiveness is able to be measured against clear performance benchmarks.

120 See: http://www.ato.gov.au/bettersuper/

Chapter 8

Self-managed superannuation funds

8.1 This chapter has two main parts. The first provides a brief overview of self-managed superannuation funds (SMSFs) including reasons for their rapid growth. This is followed by sections that address the administration, regulation and viability of SMSFs, including:

- the minimum threshold to make SMSFs viable;
- whether the current maximum number of four members of SMSFs has intergenerational utility;
- concerns over whether the Australian Tax Office (ATO) is the body most suitable to administer and regulate SMSFs; and
- whether the current Australian Financial Services (AFS) licence exemption allowing accountants to advise on the structure of SMSFs is appropriate.

Self managed super funds

8.2 Self-managed superannuation funds have become an increasingly significant part of the Australian superannuation landscape over the last five years. The Reserve Bank of Australia in its Financial Stability Review report stated that:

> By fund type, industry and self-managed funds have recorded the strongest growth in assets under management over recent years. These funds, together, account for nearly 40 per cent of industry assets, compared to around 23 per cent five years ago ... At the same time, there has been a decline in the share of total superannuation assets held in public sector and corporate funds.[1]

8.3 The number of new SMSFs reached its highest point in 2003-04, when about 3000 funds were established per month, with the figure now resting at about 1800 per month. According to the Self-Managed Super Fund Professionals' Association of Australia (SPAA), the five-year average indicates that the number of funds opening per month has actually decreased over that time, although the average balance of the funds has grown.[2]

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1 Investment and Financial Services Association, *Submission 60*, p. 23.

2 Mrs Andrea Slattery, Chief Executive Officer, SPAA, *Committee Hansard*, Sydney, 24 October 2006, p. 4.

A snapshot of the sector

8.4 Self-managed superannuation funds have become an increasingly popular way for people to hold retirement savings. Recent evidence shows that the number of SMSFs and the value of funds under their management have been increasing rapidly, with no end in sight. According to Australian Prudential Regulatory Authority (APRA) statistics issued on 28 June 2007 (for the Quarter ended March 2007) there were 337,902 SMSFs regulated by the ATO that satisfied the definition of a SMSF under section 17A of the SIS Act. The SMSF sector now accounts for 99.81 per cent of total number of superannuation funds and represents 23.3 per cent of total superannuation savings.[3]

8.5 According to the Commissioner of Taxation, Mr Michael D'Ascenzo, the SMSF market is currently growing at a rate of approximately 1800 a month and there is no sign of this rate falling.[4] APRA estimates that the number of SMSFs will grow to 344,841 as at 30 June 2007, which is a 78.31 per cent increase over the eight years from 1 July 1999. This rate of growth is clearly shown in Table 1 and Figure 1.

Table 1: Growth in SMSFs[5]

	Jun-07	Jun-06	Jun-05	Jun-04	Jun-03	Jun-02	Jun-01	Jun-00	Jun-99
SMSF's	344,841*	319,805	299,696	289,132	262,175	235,626	219,064	212,538	193,396
Increase (#)	25,036	20,109	10,564	26,957	26,549	16,562	6,526	19,142	
Increase (%)	7.83%	6.71%	3.65%	10.28%	11.27%	7.56%	3.07%	9.90%	

Average Increase (#)	18,931
Largest Increase (#)	26,957 (2003/04)
Smallest Increase (#)	6,526 (200/01)

8.6 In terms of asset holdings, SMSFs outrank both public sector and industry and corporate funds. Table 2 shows how SMSFs compare with other major fund types.

8.7 Figures from the ATO also show:

- the top five asset classes for SMSF investments are cash and term deposits (30 per cent), listed shares (21 per cent), public trusts (10 per cent), other trusts (6 per cent) and real property (5 per cent); and

3 APRA figures included in SPAA, updated statistics, July 2007.

4 *Self managed super funds – the Tax Office Perspective*, Speech by Michael D'Ascenzo, Commissioner of Taxation, National SPAA Conference, 1 March 2006.

5 APRA figures included in SPAA, *Submission 70a*, p. 4.

- the average member account balance rose from $184,490 in June 2000 to $342,500 as at 30 June 2006 (which compares with approximately $52,000 per member for public sector funds).[6]

Figure 1[7]

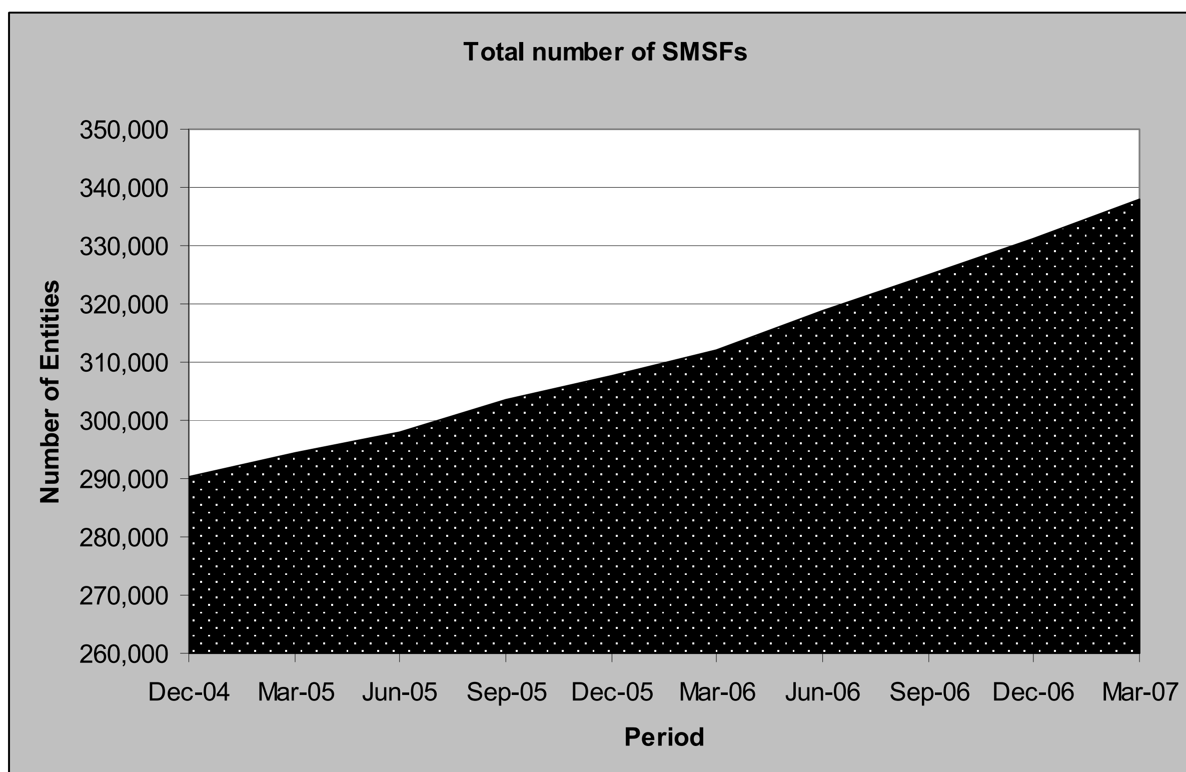

Table 2: Asset holdings of different funds[8]

Fund Type	Assets as at 31 March 2007		Entities as at 31 March 2007	
	$ billion	% Total	Number	% Total
Corporate	69.4	6.11	335	0.09
Industry	182.7	17.33	75	0.02
Public Sector	165.8	15.73	41	0.02
Retail	343.9	32.63	173	0.01
SMSF	245.6	23.30	337,902	99.81
Total	**1053.8**	**100**	**338,526**	**100**

6 APRA figures included in SPAA, updated statistics, July 2007, p. 4.

7 SPAA, updated statistics, July 2007, p. 5.

8 APRA figures included in SPAA, updated statistics, July 2007, p. 3.

Reasons for growth

8.8 Term of reference number 7 refers specifically to the reasons for growth in the number of SMSFs over the past decade. The committee notes that much of the evidence on this issue is anecdotal and speculative. A number of submitters and witnesses provided similar reasons as to why SMSFs have grown to the extent they have in recent years. First and foremost, there is general agreement within the industry that SMSFs have grown in popularity because they provide members with flexibility to control their own investments, with expectations of earning higher returns, and diversify their assets within the superannuation fund.[9] As noted by the submission from SuperRatings:

> … many Australians believe that they are able to manage assets better than traditional fund managers, which assisted in the term DIY Funds being phrased. This is no different to the managed fund area where investors are split between using traditional fund managers and investing directly in the equity markets themselves, often via web-based brokers. Not surprisingly, anecdotal evidence indicates that most SMSF money is invested either directly in the Australian equity market or held in cash.[10]

8.9 This view was also confirmed at a hearing by SPAA:

> We find that … by having control over those superannuation fund assets, people are able to make decisions about their future and they are able to invest, and time those investments, to their advantage so that, if they think that a particular investment in the market is suitable to purchase or to sell, then they can do that based on their judgement and advice they may give. The flexibility certainly comes out of that timing aspect of the particular investment. When you think about the many people who have self-managed superannuation funds, those being self-employed people or some executives, they like to control their own destiny a lot more than employees…[11]

8.10 The popularity of SMSFs is also attributed to the absence of fees charged by professionally managed superannuation funds, the ability to invest in assets not otherwise available in a regulated fund and advice from accountants and financial planners. Research conducted by CPA Australia on the SMSF market identified the main reason for the establishment of an SMSF as: '…control followed by flexibility, tax advantages and a good way of planning towards retirement'.[12]

8.11 While the committee accepts that SMSFs have become an attractive option for the reasons outlined above, dissatisfaction with larger fund performance, including the

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9 Treasury, *Submission 55*, p. 16.

10 SuperRatings, *Submission 49*, p. 7.

11 Mr Graeme Colley, SPAA, *Committee Hansard*, Sydney, 24 October 2006, p. 5.

12 CPA Australia, *Self Managed Super Funds*, A Financial Advisory Services Research Report, October 2004, p. 2.

cost burden of over-regulation and the lack of transparency regarding fees, either real or perceived, should not be underestimated as factors driving people into SMSFs.[13] A research report commissioned by the Investment and Financial Services Australia (IFSA) found that 36 per cent of respondents cited poor performance from existing funds as a reason for setting up a SMSF. The report found that:

> …clients disillusioned with returns were more likely to feel that their existing super fund was not performing well, regardless of whether this reflected underperformance or simply a drop in equity markets. As a result of this reassessment, many felt they were being charged too much by their existing super provider and opted to establish a SMSF instead.[14]

8.12 Experts within the SMSF industry have speculated that four out of five new SMSF funds will be established by newcomers to superannuation to take advantage of new 'simplified superannuation' laws that allow contributions of up to $1 million of after tax funds to be made in to retirement savings accounts. However, the committee notes that the ATO has warned people of the dangers involved in setting up an SMSF as a result of the new rules simplifying the taxation arrangements for superannuation. The ATO has encouraged anyone considering setting up a SMSF to ensure they are familiar with the rules governing SMSFs and the obligations of trustees.[15]

Committee view

8.13 The committee notes the rapid growth in the number of SMSFs over the last decade. While the committee does not have any serious concerns about the growth of the SMSF sector, it believes there are a number of potential disadvantages and risks associated with SMSFs that should not be overlooked. Specifically, there is some evidence that the significant and expanding portion of superannuation assets held in SMSFs is not protected by the industry's broader safeguards. In brief:

- SMSF's are only cost-effective for investors with significant assets. ASIC have indicated a minimum maturity figure of $250,000;
- trustees are generally inexperienced in making investment decisions and are time-poor. This may result in poor returns and funds becoming non-compliant;
- SMSFs cannot use the Superannuation Complaints Tribunal and members are not eligible for compensation for losses arising from fraud; and

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13 Association of Independent Retirees, *Submission 19*, p. 7.

14 *SMSF Trends*, Investment Trends/IFSA Self Managed Super Funds (SMSF) Report, February 2006, p. 11.

15 John Wasiliev, 'ATO warns on super fund risks', *Australian Financial Review*, 12 February 2007, pp. 1 and 56.

- trustees of SMSFs could be personally liable for members' losses.[16]

8.14 The committee notes that the statistics published by APRA on SMSFs is limited when compared with the detailed data available on other sectors in the superannuation industry. The committee believes it would be useful if the ATO (which regulates SMSFs) were to compile a representative sample of data that would enable a more useful comparison across the industry.

Regulatory and compliance arrangements

8.15 A self-managed superannuation fund is a fund in which:

- the trust deed meets the requirements of the *Superannuation Industry (Supervision) Act 1993* (SIS Act);
- there are no more than four members;
- all the members are trustees of that fund;
- no member of the fund is an employee of another member of the fund, unless they are related, and
- no trustee of the fund receives any remuneration for their services as trustee.[17]

8.16 Because all the members of SMSFs are trustees, the fund is not subject to the full range of prudential regulation and supervision. Trustees of these funds are not subject to the fit and proper requirements and other obligations imposed on trustees of APRA supervised superannuation funds. However, trustees of SMSFs still have to meet a number of obligations. These include:

- lodging an annual income tax return and superannuation fund annual return;
- lodging superannuation member contributions statements;
- reporting payments of member benefits;
- appointing an approved auditor to complete the annual audit;
- maintaining records for up to 10 years, and
- complying with investment restrictions.

8.17 Some of the key restrictions under the SIS Act applying to SMSFs include:

- meeting the sole purpose test;
- the requirement to formulate and enact an investment strategy;
- not accessing members' money without meeting a specific condition of release;

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16 Tom Valentine, 'Regulation of DIY Superannuation Funds", *The Australian Economic Review*, vol.37, no.2, 2004, pp. 216-17.

17 Leslie Neilson, *Superannuation ready reckoner: taxation and preservation rules for 2004-05-revised February 2005*, Research Brief no.10 2004-05, Parliamentary Library, pp. 18-19.

- not providing loans or financial assistance to members or relatives; and
- not borrowing money to invest.[18]

8.18 The 2006 Budget included provision for improvement in the regulation of SMSFs by increasing funding to the ATO for compliance activities, streamlining reporting requirements and other measures. It also increased the supervisory levy for these funds to $150 to place them on a similar cost recovery basis as other superannuation funds.

8.19 Before examining more commonly raised themes, the committee notes two matters which attracted limited comment, but are worth discussing nonetheless. The first of these is the difficulties faced by those running and contributing to a SMSF while living overseas for extended periods of time. Trustees residing overseas for periods in excess of two years risk having their fund deemed non-complying, on the basis that the active member test for an Australian superannuation fund requires a resident active member's accumulated benefit to be greater than 50 per cent of the total accumulated benefit for all active members. The provisions, as they stand, are overly restrictive.

8.20 It was submitted by Cavendish Superannuation that the active member test is unnecessary, because its objectives are met by other applicable laws. These include provisions which require the 'central management and control' of a super fund to take place in Australia, and which impose caps on contributions. The committee was also reminded that in order to claim a self supported contribution deduction, other Australian-sourced income would need to be declared within the Australian tax system.[19]

Recommendation 26

8.21 The committee recommends that the active member test be removed from the definition of an Australian Superannuation Fund.

8.22 The second issue of concern is the inability of a member to draw a pension from their fund in any form other than cash, whereas 'in specie' payments are available when drawing a lump sum. In practice, a member may wish to draw securities such as shares, in lieu of cash, depending of their circumstances. It was submitted that differentiating between lump sums and pensions is unnecessary because members are entitled to take lump sums as often as they took their pension, should they so desire, rendering the rule illogical. The committee sees merit in this argument, and notes the

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18 Leslie Neilson, *Superannuation ready reckoner: taxation and preservation rules for 2004-05-revised February 2005*, Research Brief no.10 2004-05, Parliamentary Library, pp. 18-19.

19 Cavendish Superannuation, additional information, pp. 1-2. Central management and control test, s contained in S.295-95 of the *Income Tax Assessment Act 1997*.

submission from Cavendish Superannuation that the tax payable on the drawings would not change.[20]

Recommendation 27

8.23 The committee recommends that fund members be able to draw superannuation pensions 'in specie', in line with existing provisions for lump sum payments.

Possibility of minimum threshold for viability

8.24 The committee received evidence that some investors are establishing SMSFs in spite of having insufficient retirement savings to make this vehicle a cost effective option. There was also anecdotal evidence that poor advice was being given by accountants and financial advisors resulting in people with modest investment capital viewing SMSFs as a viable option. Commissions payable to financial advisers and accountant fees for ongoing fund management were seen as likely factors behind such advice being given.[21] Management fees are not inconsiderable, especially in the context of a fund with modest holdings. As IFSA explained to the committee:

> I am happy to send the committee a copy of one of our surveys that indicates that the average total amount spent in fees in running a self-managed super fund is $3,500, and that is a lot of money. Once you put that as a percentage of $100,000 or $200,000, that is a very high management expense ratio. So we think it has to be around $200,000 to $250,000.[22]

8.25 At the committee's hearing in Canberra, officers from the ATO submitted that, as at June 2006, the average total asset per SMSF was about $653,000, and that the ATO 'often regarded' $200,000 as being the minimum level of viability for SMSFs. The ATO also reported that, as of 2005-06, about 34 per cent of SMSFs carried balances of less than $200,000. The Self Managed Super Fund Professionals' Association of Australia told the committee that there had been a significant reduction in the number of SMSFs with balances of less than $100,000 over recent years.[23]

8.26 The wisdom or otherwise of imposing a minimum balance on the operation of SMSFs was the subject of considerable discussion throughout the inquiry. Some witnesses were in favour of a statutory limit. Others, while mindful of the need for sufficient returns to overcome the cost of management, saw no need to regulate a viability threshold. CPA Australia submitted that:

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20 Cavendish Superannuation, additional information, p. 2.

21 See, for example, Industry Funds Forum, *Submission 73*, p. 35.

22 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, Sydney, 24 October 2006, p. 97.

23 Mrs Andrea Slattery, Chief Executive Officer, SPAA, *Committee Hansard*, Sydney, 24 October 2006, p. 4.

> In our publications we agree with the $200,000 limit only insofar as it is a reasonable dollar amount—that, if you were to look at a self-managed fund purely on a cost basis compared to, say, a retail fund, you would probably have to invest that sort of money to start getting ahead cost wise … [T]he issue really about establishing a self-managed fund is not so much how much money you have but it is the purpose you are establishing it for. People need to have a strict purpose for it. If you are just doing it for cost or because you think you can do better than a fund manager, you really need to think long and hard about what your alternatives are instead of just jumping into it … [F]unds may be established for business, in conjunction with your small business, when there is the exemption for holding assets, for holding business real property et cetera. Funds can legitimately operate quite effectively for amounts less than $200,000, and for good reason, for good purposes, so we certainly would not want to see any sort of statutory limit. I do not think it would work, and we certainly would not want to see it. I see that number just as a guide for the average person who has the barbecue discussion on the weekend about self-managed funds being the latest fad and thinks he can just go out and get one. I certainly do not think there should be a line as to when and where you can get one.[24]

8.27 Other witnesses supported the concept of a minimum balance requirement, but not necessarily at a threshold of $200,000. Professional Associations Superannuation Limited suggested the figure of $100,000 as a possible starting point:

> We have suggested that except for where there is a financial planner who has come up with a plan and suggested that the establishment of such a fund makes sense for an individual. The costs of a self-managed fund are very significant and many people establish them for the wrong reasons. What we are trying to do is encourage the consumer to not make that decision unless they have very strong advice otherwise … [O]ur submission says either $100,000 or a financial planner’s assertion that it is appropriate in that individual’s case. We would not put a timeframe. It is a categorical limit of $100,000 or $200,000—whatever you choose to have—with an out that says that if there is appropriate advice then they have the ability to set them up. It is very hard somehow to know what is particularly relevant to an individual.[25]

8.28 The need for flexibility in thresholds was also emphasised in evidence by SPAA, which submitted that generational change in the approach taken to investment and superannuation accounted for some of the popularity in SMSFs. It argued that a $200,000 threshold may unduly hamper sound investment strategies on the part of younger investors:

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24 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 50.

25 Mr Kevin Beasley, Chief Executive Officer, Professional Associations Superannuation Limited, *Committee Hansard*, 6 March 2007, Melbourne, p. 9.

> As an association whose constituents are mainly practitioners, we find that there is a knowledge attribution to self-managed superannuation funds which is found in younger professionals in the business community who are restricted by the amount that they can contribute to a self-managed superannuation fund through salary sacrifice arrangements, super guarantee et cetera. They have a better grasp of the array of investment product available to them that they can control through a self-managed superannuation fund which makes that central control and management of the fund more suitable to them for achieving their retirement objectives in relation to the accumulation of wealth through superannuation, but particularly through a self-managed superannuation fund. So the level of contributions will increase quite dramatically, but also the performance that they are targeting is a higher performance for a longer preservation period. They are inclined to want to set up these funds, albeit that there may be a higher cost as a percentage of operating the fund in the earlier years than in the latter years, in order to get the traction that they need to get these funds up and running.[26]

Committee View

8.29 The committee sees problems with the imposition of a statutory viability limit, particularly in light of its likely effect on younger investors. The committee is also mindful of the fact that, because of infinitely variable investment performance, no single threshold amount could sensibly be applied to all funds. Rather, the committee views the highly individualised advice provided by accountants and financial advisers as the appropriate safeguard for investors seeking to establish an SMSF without viable seed funding. The committee, therefore, makes no recommendation in regard to minimum thresholds.

Limiting owner numbers

8.30 At present, legislation restricts to four the number of individuals who can own and manage a SMSF. Each owner is automatically a trustee. The committee heard some evidence that this limit should be increased in response to the prevalence of family businesses and funds that operate over two or more generations. The limitation also restricts operators of small businesses with multiple owners who seek to invest together. Evidence received from the Association of Independent Retirees (AIR) called for the limit to be raised to nine or ten parties:

> We have an SMSF, and there is a concern about who is going to deal with that when we die. If the executor also has superannuation in that fund, as a trustee member, then you have confidence that the process is going to continue through. Then you get to the next stage of how many of your sons or daughters want to be in that fund. We happen to have three. We happen to have a fight with them whenever one of them wants to be nominated

26 Mr David Ruddiman, Director and Chair of Regulatory Committee, *Committee Hansard*, 24 October 2006, Sydney, p. 12.

> without the other two being involved. Because the other two also have superannuation and they want to be in the fund, we really need five members to make that work effectively. So it is not an arbitrary thing; it is a family related thing that we suggest. Many other people are in that position.[27]

8.31 SPAA echoed this position:

> You have children, whose parents now under choice are able to select the fund they will be members of, who are wanting to join their parents' fund and have their employer contribute to that fund. There is a view currently in practice that the parents are now having to decide which of the children is to be excluded from that process.[28]

8.32 It was argued that allowing more than four members to be owners and trustees of an SMSF could create other problems. The primary drawback is that the management of the fund would become too complex. This was acknowledged as a possibility even by those in favour of raising the limit.[29] Representatives from Treasury argued that the requirement that all members be trustees was intended to ensure that SMSFs are genuinely self-managed and of a sufficiently small size, and that all members are involved in decision-making and able to protect their individual interests. In a larger fund, the decision making-process is considerably more difficult and generally involves one or more members forgoing representation.[30]

8.33 A cap on the numbers of trustees at state level was also raised as a constraint to any increase at the federal level.[31] Representatives of AIR argued that corporate trustees were potentially very helpful in such situations:

> We believe there should be a lot more done by the various regulatory bodies to encourage people to consider corporate trustees. You will find in the publicity that they are not mentioned at all. Furthermore, you get very bad advice from lawyers who say, 'Don't do it,' but 35 per cent of people do it very effectively. There is no education about the best type of trustee structure an SMSF should adopt. You still run into problems in that if one member of the [fund] dies then you have to restructure the whole thing, which is complicated in a trust situation but much simpler in a corporate

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27 Dr Barry Ritchie, National Chairman, Retirees Income Group, AIR, *Committee Hansard*, 20 November 2006, Canberra, p. 110. See also Mr Graeme Colley, Director, SPAA, *Committee Hansard*, 24 October 2006, Sydney, p. 7.

28 Mr David Ruddiman, Director and Chair of Regulatory Committee, SPAA, *Committee Hansard*, 24 October 2006, Sydney, p. 14.

29 Mr Graeme Colley, Director, SPAA, *Committee Hansard*, 24 October 2006, Sydney, p. 7.

30 Ms Erica Lejins, Senior Adviser, Superannuation and Retirement Savings Division, Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 37.

31 Ms Erica Lejins, Senior Adviser, Superannuation and Retirment Savings Division, Treasury, *Committee Hansard*, 20 November 2006, Canberra, p. 37.

> trustee situation. You also have to reduce the costs of the regulation of that so that duplicate costing is not involved.[32]

8.34 Doubts were expressed by some witnesses about the seriousness of the problem. The ATO submitted that the majority of funds have only two members.[33] This of itself indicates that there is little risk in raising the limit for the minority of SMSFs that need to do so.

Committee view

8.35 The committee is persuaded by the arguments put by the AIR, SPAA and others in relation to trustee limits. The problem which exists now, on whatever scale, has particular effect for funds seeking to operate across multiple generations, as well as for co-owners of small businesses seeking to invest together. The effect of this restriction is likely only to worsen in the future, and should be addressed sooner rather than later.

Recommendation 28

8.36 The committee recommends that the ATO consider raising the maximum number of trustees for any one SMSF from four to ten, in line with current and future demand.

Recommendation 29

8.37 The committee recommends that a simple and clear alert warning should be provided to all trustees of an SMSF on their duties and responsibilities, the recommended ASIC minimum maturity figure and the absence of part 23 compensation in the event of theft and fraud.

The appropriateness of the ATO as regulator of SMSFs

8.38 The ATO has regulated SMSFs since October 1999. This involves ensuring that the primary purpose of SMSFs is to generate a retirement benefit for members and that funds are managed in line with the rules and regulations of the relevant legislation. It also involves reviewing the work of approved auditors, ensuring that trustees meet their own taxation obligations and have an investment strategy in place.

8.39 The ATO reported that, as of November 2006, approximately 290 staff were assigned to work on SMSFs. Primary tasks included the provision of information, education and advice to help trustees understand their obligations; auditing funds at high risk of not complying; checking member contribution statements to check that all contributions are reported correctly; reviewing high-risk regulatory issues; and

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32 Dr James Ritchie, National Chairman, Retirees Income Research Group, AIR, *Committee Hansard*, 20 November 2006, Canberra, p. 111.

33 Mr Stuart Forsyth, Assistant Commissioner, Superannuation, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 39.

following up auditor contravention reports. The key risks for self-managed funds were identified as including trustees not fully understanding their obligations, unauthorised early access or personal use of fund assets, breaches of in-house asset rules, acquisition of assets from related parties and failure to lodge complete and accurate returns.[34] Critically, as regulator, the ATO has no view about the wisdom of the investment strategies adopted by funds, and therefore does not give financial advice to investors.

Administration fees

8.40 The administration fee for SMSFs is set to increase by almost three-fold.[35] Representatives of the ATO explained that most of the additional revenue will feed into work on compliance, and that over two years the staff involved in compliance would increase from approximately 150 to 500. This will bring about an increase in percentage of SMSFs audited from 1.2 per cent to about three per cent.[36]

8.41 The way in which the ATO conducts its compliance activities was the subject of some discussion, much of which centred on achieving the best balance between compliance on the one hand, and reasonable administration fees on the other. The AIR discussed this at length:

> I guess it goes back to this issue: what is the most cost-effective way of having compliance regulation on the industry? The tax office process is one that relates to the tax office auditing a certain number of high-risk funds and auditors auditing every fund, but that process is not efficient because the relationship is between the trustee and their accountant—78 per cent of all trustees use accountants to prepare their accounts ... [T]he client relationship is between the trustee and the accountant. The tax office approach is to the auditor. The auditor then has to check information from the trustee. That is checked through the accountant to the trustee. It can only be done, and is done, by getting signed statements from trustees that they have not entered into any loan arrangements, that they have conformed to the act, that the trustees are eligible. They are all signed statements from that auditor to the accountant to the trustee and back from the trustee to the accountant to the auditor.
>
> That is a complex process which does not really achieve anything. The tax office said today that they were concerned that auditors were good at auditing the accounts but not at the compliance requirements, and that is the reason for it. If the focus is on accountants, and the accountants are properly trained and educated and meet the regulatory requirements, the trustees and

34 Ms Raelene Vivian, Deputy Commissioner, Superannuation, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 33.

35 Ms Raelene Vivian, Deputy Commissioner, Superannuation, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 35.

36 Ms Raelene Vivian, Deputy Commissioner, Superannuation, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 33.

> the accountants will achieve the same thing. We have said to the ATO that the design of their regulatory forms and checklists should be consistent for the trustee and the accountant. If that happens, and if they demonstrate that they conform, the need for auditing those funds is not such a requirement.[37]

8.42 Pointing to the fact that most SMSF trustees use accountants to run the fund, AIR suggested that the imposition of regular audits, even where the risk of non-compliance is very low, is an overly cautious approach. It highlighted the very low incidence of major breaches in compliance and proposed an alternative strategy involving auditing accountant-run SMSFs in their first three years of operation, after which regular auditing would be triggered only by non-compliance. Where an accountant is not used, auditing would occur annually. AIR explained how this alternative strategy would work:

> If [non-compliance] was the focus, there would not be the need to audit every fund every time. We need to recognise that the cost of that regulation is now very high. It is approaching $250 million. The cost of the audit fee and the cost of the $150 tax fee now comes close to $250 million. That is a very high cost on funds that have a relatively small $300,000 type trust which has a very simple structure in general. That is why we say it is wrong and that the audit process should be changed to reflect that.[38]

8.43 It also argued for a greater reliance on safeguards offered by accountants. It submitted that many accountants have received training from auditors on the kind of information needed to conduct audits, and that accountants are often the nexus between the ATO and the SMSF. Many aspects of compliance cannot be independently and readily checked by an auditor. These aspects are dealt with by requiring trustees to sign declarations that they meet the requirements of the legislation. Auditors require accountants to have these declarations completed by trustees. There is no reason why the accountant cannot be required to obtain these declarations in the first place without placing the onus on the auditor to obtain them through the accountant. Because of the greater knowledge that an accountant has of the affairs of an SMSF, it is far more likely that an accountant can identify improper use of funds than can an auditor.[39]

Committee view

8.44 The committee accepts the proposition that greater reliance should be placed on accountants as the key interface between members and the regulatory and compliance system. In view of the current and future growth of SMSFs it is important to ensure that the right balance is struck to minimise the regulatory burden of

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37 Dr James Ritchie, National Chairman, Retirees Income Research Group, AIR, *Committee Hansard*, Canberra, 20 November 2006, p. 111.

38 Dr James Ritchie, National Chairman, Retirees Income Research Group, AIR, *Committee Hansard*, Canberra, 20 November 2006, p. 111.

39 AIR, *Submission 19*, p. 8.

administration while also maintaining financial and legal integrity. The committee considers that, in large part, the proposal made by AIR strikes the appropriate balance.

Recommendation 30

8.45 The committee recommends that SMSFs run by qualified accountants be audited annually for three years from their commencement and, subject to no irregularities, thereafter every five years. SMSFs found to be non-compliant are to be audited annually for three further years.

Australian Financial Services Licence: accountants' exemption

Background[40]

8.46 The government has significantly reformed the consumer protection and disclosure framework overseen by ASIC since the regulator was established in 1998. In particular, the government introduced the *Financial Services Reform Act 2001*, which amended the Corporations Act to provide for a single licensing regime for financial sales, advice and dealings in respect of financial products. Under the act, any person wishing to carry on a financial services business in Australia must hold an AFS, or be the representative of an AFS licensee.

8.47 An AFS imposes a number of obligations on the licensee with respect to standards of behaviour and training. These obligations include a duty to comply with financial services laws, an obligation to have in place adequate arrangements for managing conflicts of interest and, if the relevant financial services are to be provided to consumers in a retail capacity, an obligation to allow access to an approved dispute resolution system.

8.48 On 1 December 2005, the government also introduced a series of refinements to financial services laws to improve the clarity and amount of information that consumers receive when obtaining advice about financial products. These include amendments to allow for the provision of a 'short-form' product disclosure statement that, in the case of superannuation and superannuation-like products, must include enhanced fee disclosure information. Also included are amendments dealing with the circumstances in which a Statement of Advice (SoA) must be provided in the case of an ongoing adviser-client relationship and reduced verbal disclosure requirements for advisers.

8.49 Many individuals depend on their accountants for advice and assistance with their entire business, taxation and financial affairs. Some individuals also seek the advice of financial planners. Research suggests that two main reasons cited by SMSF

40 Comprehensive background to the AFS, and in particular the accountants' exemption, can be found in this committee's report, *Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h)*, June 2004.

trustees for establishing their SMSF was advice from their accountant or financial planner.

8.50 Treasury notes that some specific activities, which by their nature do not constitute, or should not be treated as, financial services, are not subject to financial services licensing. This includes advice in relation to the structure and operation of SMSFs.

8.51 Recognised accountants that hold appropriate qualifications are able to provide advice to their clients on a decision to acquire or dispose of an interest in an SMSF without the need to be licensed under financial services regulation. This exemption, or 'carve out' as it is widely referred to, recognises that the establishment of an SMSF often forms part of an overall business strategy, which would include other advice not covered by financial services regulation, such as business structuring and taxation advice. The exemption does not cover the provision of advice on an SMSF's investment strategy. The fact is that the profession itself recognises the decision. A large number of accountants are licensed because they want or need to go beyond simply advising on structures.

Appropriateness of exemption

8.52 Witnesses conveyed widely different views on the accountants' exemption. The Financial Planning Association of Australia (FPA) called for a level playing field on the provision of advice, on the basis that all professionals seeking to offer advice in the field should be suitably licensed. To do otherwise would encourage confusion among consumers about the nature of the advice being provided:

> You might ask whether a self-managed super fund is appropriate for you versus, let us say, a managed investment or some other structure, and an accountant can certainly help you look at structures, but then you might say, 'What investment strategy should I actually undertake? Should I put my money in a growth strategy or cash or whatever?' That is where we are saying that, if you are going to provide advice that extends down the full spectrum of helping you with your end goals, then you should be licensed. It does require clarification, and we believe that providing advice is something that you should be licensed to do and that you should not stop and start the process.[41]

8.53 The Investment and Financial Services Association (IFSA) agreed, claiming that the regulatory arrangements that preceded the exemption for accountants were sufficient to deal with the problem they faced.[42] IFSA told the committee that the absence of an external dispute resolution process was an important factor when

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41 Ms Jo-Anne Bloch, Chief Executive Officer, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 42. See also Mr Michael Murphy, Past President, Association of Financial Advisers, *Committee Hansard*, 20 November 2006, Canberra, p. 91; Mr Steve Tucker, Chief Executive Officer, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 74.

42 IFSA, *Submission* 60, p. 24.

considering the future of the exemption, as it had significant ramifications for consumers caught up in a dispute.[43]

8.54 SPAA argued that the complexity of SMSFs required those advising on them to achieve accreditation at a higher level than is currently set by ASIC (PS146) and the Financial Services Education Agency of Australia. They consider that any lowering of standards, including the continued exemption of unlicensed accountants, would be unsatisfactory.[44]

8.55 The exemption was also said to complicate the job of accountants, who found the legislative boundary difficult to negotiate. Usually, accountants had the added complication of their client not recognising that a 'line' exists:

> [The] accountants’ exemption is actually very difficult to adhere to in practice, and for anyone merely to advise on the structure of a self-managed superannuation fund without getting into the advice space is difficult, as shown by the outcomes in the ASIC shadow shopping report; the majority of accountants who were surveyed actually were acting without appropriate licence authorisation. So we believe the exemption really needs to be rethought.[45]

8.56 CPA Australia examined the same issue from a different perspective, expressing frustration with the exemption as it stands. It explained that:

> Accountants are limited. If a client comes in, they can ask to have a self-managed fund established. The adviser, if he is unlicensed, has no scope to suggest that that is not the most appropriate path and maybe they should consider another type of fund … ASIC has reached a conclusion that you cannot possibly advise on going into a particular type of fund or structure of fund, unless you have considered the fund that they might already be in; whether or not they are actually switching money from that fund. Essentially, the exemption as it stands, of being able to advise on self-managed funds, does not really work at all. ASIC is expecting accountants to consider the other options and yet they are hamstrung to do so.[46]

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43 Mr Richard Gilbert, Chief Executive Officer, IFSA, *Committee Hansard*, Sydney, 24 October 2006, p. 97.

44 SPAA, *Submission* 70, p. 6.

45 Mr John Anning, Manager, Policy and Government Relations, FPA, *Committee Hansard*, 24 October 2006, Sydney, p. 42. See also Mr Hugh Elvy, Manager, Financial Planning and Superannuation, Institute of Chartered Accountants in Australia, *Committee Hansard*, 7 March 2007, Sydney, p. 25.

46 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, Sydney, 25 October 2006, p. 38.

8.57 It called for the extension of the exemption to cover superannuation structures other than SMSFs, so that suitable superannuation options, other than SMSFs, could be suggested to a client.[47]

Committee view

8.58 The committee notes that the discussion of the accountants' exemption during the inquiry echoed much of the evidence received by the committee during its 2004 inquiry into the Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h).[48] The committee believes that arguments then presented by the peak accounting bodies for an extension of the exemption to include general structural advice on *all* superannuation funds, remain valid. The committee is not inclined to change its view that the current situation which enables accountants to provide general structural advice on SMSFs but not other superannuation structures disadvantages consumers who will go back and forth from accountants to licensees searching for various 'pieces of the puzzle'.

8.59 The committee believes that arguments presented by CPA Australia for an extension of the exemption are consistent with the recommendation of this committee in relation to regulation 7.1.29A:

> The committee recommends that subregulation 7.1.29A(1) be amended to read: 'Subparagraph 7.1.29(5)(c)(ii) does not apply to a recommendation by a recognised accountant in relation to a superannuation fund structure.[49]

8.60 The committee's recommendation in effect was that accountants should be able to provide advice on the structure of superannuation funds, rather than being limited to advising on SMSFs, without being licensed as financial advisers. In making this recommendation, the committee emphasised that the exemption should be strictly limited to advice on the actual structure of superannuation funds, a view that is unchanged. The committee stated in its report that the exemption:

> …must not touch on past or future investment performances of funds, or on specific superannuation funds or products nor about a person's investment strategy in a fund. When providing information, the accountant can only speak in generic terms about the various superannuation structures or the form that funds take—SMSF, industry funds, retail and corporate funds—and definitely not about specific funds.[50]

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47 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, Sydney, 25 October 2006, p. 42.

48 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h)*, June 2004.

49 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h)*, June 2004, p. 23.

50 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment Regulation 7.1.29A, 7.1.35A and 7.1.40(h)*, June 2004, p. 23.

Recommendation 31

8.61 The committee recommends that the accountants' exemption be broadened in keeping with its previous recommendation 1 to amend subregulation 7.1.29A. This would enable accountants to advise clients on the structure of any superannuation fund, rather than being limited to advising on the structure of self-managed funds only.

Senator Grant Chapman
Chairman

Supplementary Report by Labor Members

Labor members of the committee generally believe the overall governance regime of Australia's superannuation system is very sound. Since the introduction of compulsion by the Hawk/Keating Government in 1987 the sizes of the industry and funds saved have increased dramatically and it has been governed through the trustee system in a sound and effective manner. The Superannuation Industry Supervision (SIS) Act and other regulatory improvements over the past 20 years have operated very well.

Nevertheless there can be improvements in some key areas as follows;

(i) key data including international comparison needs improvement;
(ii) much existing law and regulation could be consolidated and simplified;
(iii) the total number of accounts at 30 million with 5.7 million declared lost is a very significant structural failure;
(iv) compensation in the event of theft and fraud and employer insolvency, although small in the context of the total system, significantly harm the individuals impacted on; and
(v) there is still significant room for improvement in the self-managed fund sector where issues of governance, regulation and information require upgrading.

Accordingly Labor members agree with most of the recommendations with the following exceptions:

Recommendation 6
Most industry funds publicly tender key service provisions overseen by APRA. This may include in some cases benchmarking of partly or fully owned entities. The requirement, as the recommendation suggests, that all entities such as retail, corporate, small and self managed have competitive public tender for all aspects of their business is both impractical and unnecessary interference in the internal commercial operation of business. Labor members fund it surprising that Liberal members of the committee would support such an approach.

Recommendation 13
Compulsory unit pricing for all public offer superannuation funds is not necessary. This is a commercial decision to be made by the business not imposed by government.

Recommendation 14
Labor believes these aspects of salary sacrifice should be implemented not investigated. Further Labor believes that improvement in compensation in the event of theft and fraud and losses when an employer is insolvent of compulsory super guarantee (SG) is necessary.

Recommendation 28 and 31

These recommendations deal with the operation of self managed funds. Number 28 recommends raising the members of trustees from 4 to 10. This would see their operational use expand significantly beyond the traditional family. Given the current difficulties of governance in the sector, the rapid growth in the sector generally (4 is therefore not generally inhibiting) and lack of general support for this change the current numbers should be maintained.

Number 31 recommends yet a further extension of exemptions for accountants from regulation on giving advice on self-managed super funds. Whatever the level and detail of regulation in the SMSF sector, it should be a level playing field applying equally to all. One group, in this case accountants, should not be favoured over planners and others who advise in this sector.

Finally whilst Labor is generally supportive of the report and recommendations contained with some exceptions, it was disappointed at the over emphasis by the chair, Senator Chapman, on his dispute with Mr Garry Weaven. To reference a non response to questions is appropriate, however to attach as an appendix Hansard exchanges from 2004 on related matters detracts from the generally balanced consideration of the issues by the committee and report as a whole.

Ms Anna Burke
Deputy Chair

Senator the Hon Nick Sherry

Mr Chris Bowen MP

Senator Penny Wong

Appendix 1

Submissions received by the Committee

1. Mr Geoff Taylor
2. Mr Richard Jacobs
3. Mr Steve Blizard

3a Mr Steve Blizard

4. Mr Malcolm McLelland QC
5. M J Cribbin
6. Mr Andrew Dempster
7. Compass Financial Management
8. Warren J Welch Pty Ltd
9. M J Langtry & Associates Pty Ltd
10. Financial Index Australia Pty Ltd
11. Financial Lifestyles Solutions
12. Mr George Caredes
13. Standard letter from professional financial planners
14. Heffron Consulting Pty Ltd
15. Mr Peter O'Toole
16. Mr John Bastick
17. Aon Financial Planning & Protection
18. Fiducian Portfolio Services Limited
19. Association of Independent Retirees Ltd
20. Jim Connor Financial Services Pty Ltd
21. Mr Howard Grant
22. Mr Peter Mair

22a Mr Peter Mair

23. AFS Group Ltd

24. Cartwright Brown & Company Financial Planning Pty Ltd

25. Symes Warne & Associates Limited

26. Superannuated Commonwealth Officers' Association

27. Ms Carol O'Donnell

28. Corporate Superannuation Association

29. Mr Matthew Stevens

30. Equipsuper Pty Ltd

31. Total Portfolio Management

32. Principal Murphy Financial Solutions Pty Ltd

33. Superannuation Australia Pty Ltd

34. Superannuation Complaints Tribunal

34a Superannuation Complaints Tribunal

35. Genesys Wealth Advisers Limited

36. Australian Tax Office

37. Asteron Limited

38. Financial Planning Association of Australia Ltd

39. Aon Wealth Management Limited

40. Hillross Financial Services Limited

41. Garvan Financial Planning

42. Retireinvest

43. The Institute of Chartered Accountants in Australia

44. Bendigo Financial Planning

45. AXA Asia Pacific Holdings

46. Infocus Money Management

47. Media, Entertainment & Arts Alliance
48. Australian Securities & Investments Commission
49. SuperRatings Pty Ltd
50. Australian Retailers' Association
51. Australian Prudential Regulation Authority
52. Rainmaker Information Pty Ltd
53. InvestWest Pty Ltd
54. REST Superannuation
55. The Treasury
56. RCSA and PASL
57. Meat Industry Employees' Superannuation Fund Pty Ltd
58. Mr Alex Berlee
59. Count Financial Ltd
60. Investment & Financial Services Association

60a Investment & Financial Services Association

61. Watson Wyatt Worldwide
62. Association of Financial Advisers
63. HOSTPLUS Pty Ltd
64. Members Equity Bank
65. CPA Australia
66. Australian Chamber of Commerce and Industry
67. Superpartners Pty Ltd
68. The Association of Superannuation Funds of Australia
69. Health Super Pty Ltd
70. Self-Managed Super Fund Professionals' Association of Australia Limited
71. Mercer Human Resource Consulting Pty Ltd

72. ACTU
73. Industry Funds Forum
74. Sunsuper Pty Ltd
75. CHOICE
76. Law Council of Australia
77. Industry Super Funds Network
78. Ai Group
79. Australian Institute of Superannuation Trustees
80. Trowbridge Deloitte Limited
81. Australian Executor Trustees Limited and Trust Company Superannuation Services Limited
82. UniSuper Management Pty Ltd
83. MLC Limited
84. Real Estate institute of Australia
85. ESI Super
86. UnitingCare Wesley
87. SPECQ, AUST, CLUB, QEIC, ISPF
88. Australian Bankers' Association Inc
89. Colins House Financial Services Pty Ltd
90. Mr Roger Gay
91. Australian Hotels Association
92. Broadly Based Financial Services Ltd
93. The Society of Superannuants
94. Mr Colin Grenfell and Mr Ray Stevens

95 Cavandish Superannuation Pty Ltd

96 Mr Simon Drimer

Many submitters sent in a standard letter concerning superannuation. These submissions were each accepted but listed only once, as Submission 13. The following submitters provided these letters:

Mr Steven Mandalidis, Inform Financial Services
Mr Tony Perkins, Count Wealth Accountants
Mr David Hall, Mr David Kissane, Ms Irene Kay, Lifestyle Financial Services
Mr David Evers, Robson Chartered Accountants
Mr David Robson, Robson Chartered Accountants
Mr Peter Reid, Specialist Consulting Group
Mr Tony Bergman, Godfrey Pembroke Financial Consultants
Mr Stephen O'Donoghue, Vaughan & Monaghan
Mr Paul Hudson, Hudson Gore Financial Services Pty Ltd
Mr Barry Vandenbergh, Matrix Planning Solutions
Mr Michael Coorey, Matrix Planning Solutions
Mr Nathan Foss, Investor Financial Planning
Ms Leanne Woodhouse, Financial Planning Services Pty Ltd
Mr Garry Heazlewood, Count Wealth Accountants
Mr Gerry Lenihan, Internexus Planners Pty Ltd
Mr Steven Chandler, Hillross Financial Limited
Mr John Osborne, Osborne Yuille Financial Planning
Mr David Lee, CU Financial Advisory Services Pty Ltd
Ms Eileen Luu, Australian Financial Services Pty Ltd
Mr Bob White, Sentinel Wealth Management
Mr Richard Tasich, First Capital Planning Pty Ltd
Mr Michael Baker, Baker Financial
Mr Mark Barling, AXA Financial Planning
Mr Don Jeffers, D & A Jeffers Pty Limited
Mr Raymond Mollica, Birchmount Pty Ltd
Mr Rodney Rose, Sydney Financial Services
Mr Michael Purcell, Purcell Financial Services
Ms Cathy Lowder, Fryer Financial Services
Mr Jim Fryer, Fryer Financial Services
Ms/Mr Anjan Das, CU Financial Advisory Services Pty Ltd
Ms Alice Grabowski, Financial Services Partners
Mr Stephen Bennetts, AMP Financial Planning
Mr Peter Lambert, Godfrey Pembroke Financial Consultants
Mr Wally Franks, Australian Financial Services Limited
Ms Laura Menschik, WLM Financial Services Pty Ltd
Mr Richard Bejah, Financial Planner
Ms Lynette Dyball, Financial Planner
Mr Bruce Gingell, Financial Planner
Mr Brenton Pittman, Financial Planner
Ms Sandra Bowley, Sandra Bowley Financial Professionsal Pty Ltd
E L Watson
Ms Louise Woodger, Calliva Wealth Pty Ltd
Ms Marlene Blinco, Financial Planner

Mr Geoff Havenstein, Financial Planner
Mr John Gagen, Financial Planner
Mr Phil Lamplough, Certified Financial Planner
Mr Ron Saltz, Certified Financial Planner
Mr Mal Foubister, Financial Planner
Mr James Willis, Financial Planner
Mr Charles Galafaro, Certified Financial Planner
Mr Shane Chapman
Ms Alexandra Pearn
Mr William Golder, HindSight Planning (HSP) Pty Ltd
Mr Warwick Hodge, Hillross Financial Services Limited
Mr Peter Maaaurer, WealthPath Financial Services Pty Ltd
Mr Tonhy Arlidge, WealthPath Financial Services Pty Ltd
Mr Alan Swan,Alan Swan & Associates Pty Ltd
Mr Ngan Quang
Mr Joel Campbell, Frist Capital Financial Planning Pty Ltd
Mr Phillip Campbell, Financial Planner
Mr Richard Hogg, Sentinel Adviser Services
Ms Penny Davis, Sentinel Adviser Services
Mr Mathew Taylor
Mr George Hluchaniuk
Ms Teresa Henley
Mr Rob Howell, Genesys Wealth Advisers
Mr Jim McAuld, Catholic Development Fund
Ms Dnaine McMaugh, Genesys Wealth Advisers Ltd
Mr Bruce Ayliffe, Financial Planner
Mr Tim Targett, Financial Planner
Mr Jonathan Elliott, Genesys Wealth Advisers Ltd
Mr Peter Krstic, SMF Wealth Management Pty Ltd
Mr Michael Spinks, Genesys Wealth Advisers
Mr Rob Adams, Collins SBA Genesys
Mr Alan Palmer, SMF Wealth Management Pty Ltd
Mr David Cairns, Sentinel Adviser Services
Ms Joanne Clay, Horwath Financial Services
Mr Michael Drage, Perspective Group
Mr Ian Roberts, LR Financial Services Pty Ltd
Ms Bronwen Batty, Your Vision Financial Planning
Ms Marion Craft, St George Bank Limited
Mr Michael J Woolley
Mr Mark Harding
Mr Graham Campbell, AON Wealth Management Ltd
Mr Nabil Khalil, AXA Financial Planning Limited
Mr Peter Scruton, AON Financial Planning & Protection Limited
Mr Grant Howe, Genesys Wealth
Mr Alan Norval, Financial Services Partners
Mr Richard Wiaczek, Genesys

Mr Graeme Farrell, Connect Credit Union
Mr George Straker
Mr Ross Marrett, Hillross Financial Services Pty Ltd
Mr Brad Turnbull, Hillross Financial Services Pty Ltd
Mr Todd Peters, Hillross Financial Services Ptt Ltd
Mr Paul Whitelaw, MacFarlane Financial Services
Mr David Whitelaw, MacFarlane Financial Services
Mr Colin Bishop, Count Financial Limited
Ms Trudy Winter, Count Financial Limited
Ms Nicole Gauci, Count Financial Limited
Ms Jacqueline Lynch, Count Financial Limited
Mr Kim Scott, Kim Scott Financial Planning
Mr Ron Fitton, Matrix Planning Solutions
Ms Sandra Hopps, Matrix Planning Solutions
Mr Martin Jones, Hillross Financial Services Ltd
Mr Harry Clarsen, Clarsen & Associates Pty Limited
Mr Scot Andrews, Fiducian
Mr David Millard, Aon Wealth Management Limited

Appendix 2

Public Hearings and Witnesses

<u>TUESDAY, 24 OCTOBER 2006 – SYDNEY</u>

Self-Managed Super Fund Professionals' Association of Australia Ltd

Mr Graeme Colley, Director,

Mr David Ruddiman, Director, and Chair of Regulatory Committee

Mrs Andrea Slattery, Chief Executive Officer

Association of Superannuation Funds of Australia

Ms Philippa Smith AM, Chief Executive Officer

Dr Michaela Anderson, Director, Policy and Research

Dr Pragnell, Principal Policy Adviser

Mr Ross Clare, Mr Ross William, Principal Researcher

Financial Planning Association of Australia Ltd

Ms Jo-Anne Bloch, Chief Executive Officer

Ms Glenese Keavney, Member, Superannuation Committee

Mr Brian Pollock, Member, Superannuation Committee

Mr Keith Powell, Member, Superannuation Committee

Mr John Anning, Manager, Policy and Government Relations

REST Superannuation

Mr Damian Hill, Chief Executive Officer

Ms Brenda Mills, Manager, Legal Risk and Compliance

Rainmaker Information Pty Ltd

Mr Alex Dunnin, Executive Director, Editorial and Research

Investment and Financial Services Association Ltd

Mr Richard Gilbert, Chief Executive Officer

Mr David O'Reilly, Policy Director

WEDNESDAY, 25 OCTOBER 2006 – MELBOURNE

Superpartners Pty Ltd

Mr Frank Gullone, Chief Executive Officer

Mr Paul Collins, Manager, Legal Services

Members Equity Bank

Mr Anthony Beck, Head, Workplace Business and Direct Marketing

CPA Australia

Mr Michael Davison, Superannuation Policy Adviser

Ms Noelle Kelleher, Member, Financial Advisory Services Centre of Excellence

Mercer Human Resource Consulting Pty Ltd

Mr John Ward, Principal and Manager

Mr David Knox, Principal

Australian Institute of Superannuation Trustees

Ms Susan Ryan AO, President

Mr David Coogan, Treasurer

Ms Fiona Reynolds, Director

Ms Peta-Gai McLaughlin, Manager, Legal and Compliance

Equipsuper Pty Ltd

Mr Robin Burns, Chief Executive Officer

Mr Barry Anderson, Company Secretary

Ms Cynthia Lui, Corporate Lawyer

Industry Funds Forum

Mr Ian Silk, Convenor

Mr Paul Watson, Executive Member

Ms Helen Hewett, Executive Officer

MONDAY, 20 NOVEMBER 2006 – CANBERRA

Treasury

Mr Chris Legg, General Manager, Financial System Division

Mr André Moore, Manager, Prudential Policy, Superannuation and Insurance Unit, Financial System Division

Mr David Love, Manager, Investor Protection Unit, Corporations and Financial Services Division

Ms Erica Lejins, Senior Adviser, Superannuation and Retirement Savings Division

Australian Tax Office

Ms Raelene Vivian, Deputy Commissioner, Superannuation

Mr Stuart Forsyth, Assistant Commissioner, Superannuation

Australian Securities and Investments Commission

Mr Malcolm Rodgers, Commissioner (A/g), and Executive Director, Regulation

Ms Delia Rickard, ACT Regional Commissioner & Deputy Executive Director, Consumer Protection & International

Mr Mark Adams, Director, Policy and Research

Ms Louise du Pré, Assistant Director, Super/Life (PDS Disclosure)

Association of Financial Advisers

Mr Richard Klipin, Chief Executive Officer

Mr Dennis Bateman, National President

Mr Michael Murphy, Past President

Mr Mervin Reed, Member

Association of Independent Retirees

Mr Robert Lind, National President

Mrs Helen Sava, Company Secretary

Dr Barry Ritchie, Chairman, Retirees Income Research Group

MONDAY, 5 MARCH 2007 – MELBOURNE

Superannuation Complaints Tribunal

Mr Graham McDonald, Chairperson

Ms Jocelyn Furlan, Deputy Chairperson

Mrs Katy Adams, Legal Counsel

UniSuper

Ms Ann Byrne, Chief Executive Officer

Mr Paul Murphy, Executive Manager, Marketing and Business Development,

Corporate Superannuation Association

Mr Mark Cerche, Chairman

Mr Bruce McBain, Chief Executive Officer

Australian Council of Trade Unions

Mr Nixon Apple, Industry and Investment Policy Advisor

Ms Catharine Bowtell, Industrial Officer

TUESDAY, 6 MARCH 2007 – MELBOURNE

Recruiting and Consulting Services Association and Professional Association Superannuation Limited

Mr Kevin Beasley, Chief Executive Officer (PASL)

Mr Ross Fisher, Chair, Taxation and Superannuation Committee (RCSA)

Industry Super Network

Mr Garry Weaven, Spokesperson

Mr David Whiteley, Executive Manager

Ms Robbie Campo, Project Manager

Australian Chamber of Commerce and Industry

Mr Michael Potter, Director, Economics and Taxation

Mr Daniel Mammone, Workplace Relations Adviser

Mr Dick Grozier, Director, Industrial Relations, New South Wales Business Chamber

Health Super Pty Ltd

Mr Christopher Clausen, Chief Executive Officer

HostPlus

Mr David Elia, Chief Executive Officer

Mr David Elmslie, Independent Chair

The Hon Peter Collins, AM, QC, Director

Mr Bob Hinkley, Independent Director

Mr Brian Daley, Member Director and Deputy Chair

Mr Mark Robertson, Employer Director

WEDNESDAY, 7 MARCH 2007 – SYDNEY

SuperRatings Pty Ltd

Mr Jeff Bresnahan, Managing Director

Institute of Chartered Accountants in Australia

Dr Barbara Carney, Manager, Government Relations

Mr Hugh Elvy, Manager, Financial Planning and Superannuation

Choice

Dr Nicholas Coates, Senior Policy Officer, Superannuation and Financial Services

Towbridge Deloitte

Mr Anthony Asher, Consultant

Mr Andrew Gale, Partner

Law Council of Australia

Mr Terry Brigden, Member, Superannuation Committee

Australian Industry Group

Dr Peter Burn, Associate Director, Public Policy

MLC

Mr Dallas McInerney, Government Affairs

Mr Steve Tucker, Chief Executive Officer

Australian Prudential Regulation Authority

Mr Ross Jones, Deputy Chairman

Mr Keith Chapman, General Manager, Policy Development

Mr Senthamangalam Venkatramani, General Manager (Central), Specialised Institutions Division

Ms Merrie Hennessy, Adviser, Policy Development

Appendix 3

Additional information, tabled documents, and answers to questions on notice

Additional Information

Association of Financial Advisers

Member survey regarding fee charges and value for clients when working with financial advisers

Australian Taxation Office

DIY Super – It's your money....but not yet! Explains the ATO's position on self managed superannuation funds, July 2004

Role and responsibilities of trustees, November 2005

Association of Independent Retirees (AIR) Ltd

Detailed Report on National Survey of Members, 30 October 2006

CPA Australia

Financial Advisory Services Research Report – Self Managed Super Funds, October 2004

Guidance Note for Advising on SMSFs, Guidance for CPA Public Practitioners, October 2006

A Plan to Simplify and Streamline Superannuation, 7 August 2006

Pre-Budget Submission 2007-08, November 2006

Financial Planning Association of Australia

Submission to Treasury, Proposals Paper, Corporate and Financial Services Regulation Review, 25 January 2007

Investment and Financial Services Association Ltd

Investment Trends/ IFSA Self Managed Super Funds, February 2006

Submission to Government on definitions of advice, 29 May 2006

Personal versus General Advice (Item 1.17 of the Corporate and Financial Services Review), draft submission to Treasury, September 2006

Self Managed Super Fund Professionals' Association of Australia Ltd

Self-managed superannuation fund statistics, 4 April 2007

Self-managed superannuation fund updated statistics, 30 July 2007

Superannuation Complaints Tribunal

...how it can help you, booklet, June 2005

Letter to The Hon Mal Brough MP, Aboriginal CDEP Policy, 15 February 2006

Letter to Hon Joe Hockey MP, Aboriginal CDEP Policy, 24 January 2007

Letter to Committee explaining difficulties members may experience when trying to understand benefits and exit fees, 28 March 2007

Letter to Hon Joe Hockey MP, Aboriginal CDEP Policy, 14 August 2006

Unisuper

Article, Approach to member education and advice, February 2007

Investing for the future – Your guide to investment choices in Unisuper, booklet, July 2006

Unisuper investment choice calculator, July 2006

Tabled documents

Industry Super Network, Response to Speech of Senator Chapman incorporated in Hansard – 1.56am, 24 June 2004, 6 March 2007

Financial Planning Association of Australia Ltd, *Why do clients need ongoing advice?*, 24 October 2007

Answers to questions on notice

Association of Superannuation Funds of Australia Ltd, 24 October 2006

Self Managed Super Fund Professionals' Association of Australia Ltd, 24 October 2006

REST Superannuation, 24 October 2006

Financial Planning Association, 24 October 2006

CPA Australia, 25 October 2006

Equipsuper, 25 October 2006

Industry Funds Forum, 25 October 2006

Superpartners, 25 October 2006

Members Equity Bank, 25 October 2006

Mercer Human Resource Consulting, 25 October 2006

Australian Taxation Office, 20 November 2006

Department of the Treasury, 20 November 2006

Australian Securities and Investments Commission, 20 November 2006

Unisuper, 5 March 2007

ACTU, 5 March 2007

Trowbridge Deloitte, 7 March 2007

Australian Prudential Regulation Authority, 7 March 2007

Appendix 4

Senator Chapman's Adjournment speech, Industry Super Network's response and Questions on Notice to Industry Super Network and Mr Garry Weaven

Senator Chapman, Adjournment speech, Industry Funds Services Pty Ltd, *Senate Hansard*, 24 June 2004, p. 25079

Given the propensity of the Labor Party to demand full disclosure and transparency regarding fees and charges levied by for-profit managed and superannuation funds, it is appropriate to raise some issues concerning an organisation called Industry Funds Services Pty Ltd or IFS, a company that provides funds administration services for a large number of industry superannuation funds.

IFS' 2002-2003 "Report to Industry Superannuation Funds" carried an article on corporate governance. The article noted that recent corporate failures such as Enron, WorldCom, HIH and One.Tel had:

> renewed interest in the adequacy of company information to the market, the veracity of company accounts as well as the excessive remuneration and rewards—with little or no correlation to company performance—afforded to directors and executives.

Then followed a paean to corporate campaigning.

This is ironic given the lack of transparency involved in the administration of Industry Funds Services, or IFS, itself.

IFS operates numerous financial services companies and says it manages over $20 billion in superannuation assets on behalf of the 2.8 million members of IFS' shareholders. Other reports suggest it manages combined assets of over $30 billion.

Despite controlling such vast amounts of money on behalf of so many workers, nowhere does IFS Pty Ltd's management fees, nor the cuts taken by other parts of its group, appear to be detailed for ordinary members.

IFS' reports to Industry Superannuation Funds are a mixture of self-promoting puff and amorphous financial information. Its actual income is impossible to ascertain.

Of particular concern is the amount of income derived by Industry Funds Services Staff Equity Trust, or IFS-SET Pty Ltd, which has been one of IFS' key shareholders.

IFS currently has 600 shares. Most are owned by large industry super funds, such as HESTA, C-BUS, CARE Super, Savings Australia and the Australian Retirement Fund.

However, 12.5% of IFS has been owned by IFS-SET Pty Ltd. IFS-SET has been in turn owned by just three people—Garry Weaven, Mavis Robertson and Graeme Grant and is the trustee for the IFS-SET which I have been told is a Superannuation Fund of which the major beneficiaries would be likely to include these three people.

Garry Weaven is well known as a former ACTU Assistant Secretary who has risen to dizzy heights with IFS.

Mavis Robertson is less well known. She was CEO of C-BUS until 1997.

A former communist party official, she “fell into” superannuation in the mid eighties when doing publicity for the ACTU.

Graeme Grant has been associated with a number of ACTU financial enterprises.

One may well ask, if this is a superannuation fund, how the 12.5%—and a greater percentage in earlier years—interest in IFS Pty Ltd held by the Staff Equity Trust fits the requirement that a superannuation fund have no more than 5 per cent of its assets in a beneficiary’s employer’s company?

It is not known what income IFS-SET Pty Ltd has derived from its interest in IFS.

It could quite easily run into many millions of dollars.

It is implausible that all IFS’ profits have gone to the members of the superannuation funds that use IFS.

Yet this was the theme of a major television advertising campaign, launched by IFS and featuring former Reserve Bank Governor, Bernie Fraser, that went to air in the latter part of last year.

Recently, Bernie Fraser, castigated bank executives’ “scandalous” salary packages.

In the February 2004 IFS Report, Garry Weaven, IFS Executive Chair says “no elaborate justifications of outrageous executive and director remuneration packages.”

Maybe. Maybe not.

It might comfort members of industry superannuation funds if they knew what income IFS-SET has derived from its extensive involvement in the administration of their superannuation savings.

They might then be able to determine whether or not the benefits to Mr Weaven and the very limited number of other beneficiaries of IFS-SET have been excessive.

These issues were raised in a paper by Mr Peter Johnston, Chief Executive Officer of the Association of Independently Owned Financial Planners, who said “most industry funds do not fully disclose the true cost of administration to their members and the market’s dominant player, Industry Funds Services Pty Ltd (IFS), has relationships we find difficult to understand.”

Recent Chant West research has confirmed his claims.

He then stated:

> Many choose to only disclose $1 or $1.50 per week as ‘the only fee’ which we do not believe to be the case. A close look at the annual report and balance sheet of many high profile funds will reveal that the cost is substantially more, as high as 5%.

Let us hope that in fully complying with the spirit as well as the letter of the Howard Government’s new FSR Act, industry funds will fully disclose to members the cost of the services provided by Industry Funds Services Pty Ltd.

Peter Johnston’s paper seems to have prompted Garry Weaven and the Staff Equity Trust to capitulate rapidly to distribute its interest in IFS elsewhere. According to the Financial Review of 30 January 2004:

> The deal, likely to be announced soon, may quieten some of the controversy which has swirled around IFS and its chairman, including recent criticism by....Adelaide-based....Association of Independently Owned Financial Planners.

Will IFS’ imminent transition from a superannuation fund administration business to a banking model provide a pretext for restructuring Mr Weaven and others’ interests in this lucrative business?

It is not the first time this has happened.

As I indicated earlier, IFS-SET has recently owned 12.5% of IFS. Between 1998 and 2001 it owned 15% and before this, 20%.

It thus has already had two sell-downs of capital from which its three principal beneficiaries presumably benefited. On these previous occasions, though, it is not known what consideration was received, and this is likely to be the case again.

Undoubtedly there is a lack of transparency at the moment.

Despite the “deal” to which Barrie Dunstan made reference in that AFR article and despite detailed investigations, I have been unable to find out what, if anything, has happened regarding IFS-SET Pty Ltd’s shareholding in IFS Pty Ltd or to the accumulated assets in the superannuation fund.

Certainly, IFS-SET Pty Ltd no longer appears as a shareholder in IFS Pty Ltd in the chart at the back of IFS' February 2004 Report.

Why has there been no public announcement as to exactly what has happened?

There are plenty of rumours around—one version in circulation is that the accumulated assets in Staff Equity Trust have been rolled over to other superannuation funds and that some of these assets have been allocated to other current or former employees of SES Pty Ltd who, according to this version of events, for years were promised but have been denied equitable membership of the Staff Equity Trust.

I have been told also that this recent allocation has occurred only because of considerable pressure and potential for political embarrassment being applied to Mr Weaven.

However, I am told further that the lion's share of the assets, amounting to many millions of dollars, has gone to the accounts of the three principal beneficiaries.

The question is: have a few people profited enormously from not-for-profit superannuation funds?

One thing is certain—a complete lack of transparency means that no-one knows the answer—and how much this has cost industry fund members.

It will also be interesting to see whether or not Mr Weaven and others re-emerge in the new Members Equity Bank with "scandalous" salary packages.

Transparency is one important issue in this saga. Conflict of interest is another.

As a shareholder of IFS-SET Pty Ltd and beneficiary of the Staff Equity Trust, Mavis Robertson obviously had an interest in C+BUS continuing to use Industry Funds Services Pty Ltd, while a Director of C+BUS.

Graeme Grant was recently appointed incoming fund secretary of C+BUS, yet he is still a director of IFS, which raises similar issues.

Such issues of corporate governance and transparency need to be addressed. Fund members need to be sure that their savings are invested on the basis of best return and administration.

I understand that some of the above issues have been referred to APRA.

They need to be examined fully, as does IFS' metamorphosis from superannuation administrator to bank.

Lately ASIC has been of the opinion that the practice of industry superannuation funds directing members' enquiries straight through to IFS—which picks up the calls without identifying that it is an entirely separate funds administration company—breaches the "holding out" provisions of the Corporations Act.

In other words, ASIC believes that IFS is “holding out” to be the super fund itself, rather than an administration company.

This is how perceived conflicts can arise.

The sooner ordinary workers get transparency of administration of their industry superannuation funds the better informed and better off they will be and more able to apply effectively the choice of fund provisions which, despite the best attempts of the Labor Party, has at long last been delivered to them by the Howard Government.

Response to Speech of Senator Grant Chapman incorporated in Hansard: 1 .56 am, 24 June 2004

The Senator's speech contains many falsehoods, inaccuracies and misleading statements. This submission seeks to deal with the more serious of those and is made on behalf of Garry Weaven, Executive Chair, Industry Fund Sendees Pty Ltd (IPS), Mr Sandy Grant, Managing Director of IPS and IPS Pty Ltd itself.

The Senator's speech has been informed by at least one commercial competitor of IPS and by the Government Members' Secretariat. The falsehoods and inaccuracies could easily have been avoided by basic examination of the public record, including Government records and/or by checking with the office of IPS itself. No attempt was made to contact that office. We are of the belief that the statement was .made deliberately with the intent of being circulated to the press and thereby causing damage to us and to the reputation of industry superannuation funds that are vigorous competitors with the sales commission driven, commercially operated superannuation funds.

We therefore believe that the speech represents an abuse of Parliamentary privilege and have publicly invited the Senator to repeat outside of the protection of Parliamentary privilege the allegations he has made.

The Senator complains of lack of transparency in the dealings of IPS and states that IPS says it manages over $20 billion in superannuation assets. IPS has never said it manages over $20 billion in superannuation assets. Its current funds management business has slightly over $5 billion in assets under management or advice. IPS is a proprietary limited company, owned by nine industry superannuation funds that have invested in it for both commercial and strategic reasons. It has been a successful company on both counts. All fees received by IPS are of course fully disclosed to both clients and shareholders. Its fees are widely recognised as being below market due to its lower cost structure. There is a degree of overlap between shareholders and clients. All shareholders are represented on the Board of IPS, which meets not less than five times per year. Company accounts and financial statements are presented to each meeting and the company is audited annually by PricewaterhouseCoopers. In addition, IPS publishes, on a six monthly basis, a report that, amongst other things, fully details IPS' lines of business. This report is circulated not. only throughout the superannuation industry but also to media and opinion leaders. Industry superannuation funds are subject to the full force of the law and regulation governing the superannuation industry and have been leaders in accountability and disclosure. They are also leaders in low cost performance and high net^benefit to members, a fact recognised by every independent study, including the one selectively quoted by Senator Chapman. Such funds are typically governed by trustee boards equally representing the nation's leading employer organisations and unions or their peak councils.

Senator Chapman says, "Of particular concern is the amount of income derived by Industry Fund Services Staff Equity Trust, or IPS SET Pty Ltd, which has been one of

IPS' key shareholders". IPS SET Pty Ltd was in fact a single purpose company which derived no income but simply acted as trustee for the former equity holding of IPS staff.

Senator Chapman says that he has been told that. IPS SET is a superannuation fund of which the major beneficiaries would be likely to include Garry Weaven, Mavis Robertson and Graeme Grant. As stated, IPS SET is not a superannuation fund. Tins would be an extremely simple fact to verify. It appears that many of the other alleged concerns of Senator Chapman flow from this basic misunderstanding,, if indeed it really is a misunderstanding. Mavis Robertson is not and never has been a beneficiary of the Staff Equity Trust as she has never been a staff member of 1FS. Simply she has served on the trustee board of the Trust in an unpaid capacity on behalf of the Board of IPS itself.

Senator Chapman alleges that the Staff Equity Trust had two sell downs of capital prior to being sold out and states, "…it is not known what consideration was received….". Throughout his speech he makes a number of statements alleging or implying impropriety in dealing with staff equity.

There have been no such "sell clowns" of capital. It is true, that Weaven was die largest unitholder in the Staff Equity Trust. This is hardly surprising given that he was die founding and sole employee over 10 years ago and that he arranged the seed funding by way of a capital injection from a subsidiary of the then Colonial Mutual (which was subsequently paid out from retained earnings). The company was restructured in late 1995 to be 20% owned by each of four major industry super funds and die Staff Equity Trust. Additional industry fund shareholders were added by injecting modest amounts of working capital and thus proportionately diluting existing shareholders. In 2001, two further capital injections totalling $2 million were raised from shareholders. Weaven and Grant contributed to this raising but were unable to participate to the full extent of their holdings and were therefore further proportionately diluted at that time.

Prior to the final sale of the Staff Equity Trust units, no payments have been made to staff unithoiders. All profits have been reinvested in the business. The Staff Equity Trust sale forms part of a series of restructurings which are intended to ultimately result in the integration of IPS and its various businesses into Members Equity, the bank 100% owned by 43 superannuation funds. This would then create a new mutually and wholly Australian, owned diversified financial institution. It is believed that the industry superannuation fund shareholders have achieved a higher return for their members from their investment in IPS than from any other investment or class of investments. The value of IPS for the purpose of the sale was independently determined at $15.3 million. It is estimated that the total value of IPS would currently be somewhere in the vicinity of $20 million and the business continues to grow quite rapidly. By agreement with APRA, IPS is valued every three years for the purpose of establishing a value in the books of its superannuation shareholders. The current value of Members Equity is somewhere in excess of $300 million. W;e believe that it is currently Australia's most rapidly growing bank, albeit from a small base.

Senator Chapman poses the question, "Will IPS' imminent transition from a superannuation fund administration business to a banking model provide a pretext for restructuriiig Mr Weaven. and others' interests in this lucrative business?" IPS is not a superannuation fund administration business. Further, it is clear from the above, much of which has been previously placed on the public record, that it is not intended that staff will have an interest, in the business.

Senator Chapman states that he understands "that some of the above issues have been referred to APRA". Indeed, the entire restructuring plan involving IPS, Development Australia Fund, AUSfund and Members Equity was the subject of a briefing in advance to APRA initiated by IPS. IPS has recently been assured by APRA that it has no matters of concern in relation to IPS' activities.

Senator Chapman alleges that "ASIC has been of the opinion that the practice of industry superannuation funds directing members' enquiries straight through to IPS - which picks up the calls without identifying that it is an entirely separate funds administration company — breaches the "holding out" provisions of the Corporations Act". IPS does not act as a superannuation fund administrator and does not pick up any calls on behalf of superannuation funds. Mr Weaven is Chair of Superpartners Pty Ltd, which is an administration company owned by a number of its client funds. For many years the administration contracts between those superannuation funds and Superpartners have required Superpartners to have a team dedicated specifically to that superannuation fund and to identify itself to the members in the name of that fund. Because of the changing regulatory environment, the IPS Compliance Manager last year raised this matter with ASIC on behalf of Superpartners and its clients, seeking clarification as to whether any change in the practice would be required or any exemption from any regulation was needed. On 22 September 2003, ASIC replied to Freehills in relation to this matter in the following terms:

> Thank you for your letter dated 29 August 2003 in connection with die practice of "silent administration" as conducted by your clients.
>
> The general policy of the Australian Securities and Investments Commission ("ASIC") is not to provide legal advice in relation to how various provisions of the Corporations Act 2001 (the "Act") should be interpreted. However, we recognise that you would like an indication of ASIC's current views to facilitate compliance by your clients. In that regard, ASIC does not disagree with die conclusion that s 911C(c) of die Act is not breached if the trustee and its administrator each hold an Australian Financial Sendees Licence and the administrator acts on behalf of the trustee pursuant to the terms of the administration agreement as described in your letter.

This is a further example of Senator Chapman twisting events to suit an apparent ideological bias against IPS and the industry superannuation fund sector.

The industry superannuation fund network has consistently argued for maximum disclosure of fees and charges of superannuation funds and for the outlawing of sales commissions in the selling of compulsory superannuation as a precondition for a

successful choice of fund regime. This argument has not been successful and, as aconsequence, the practice of financial planners (and others receiving commissions such as accountants) in directing people into superannuation funds that pay sales commissions, rather than into the funds which will deliver the greatest net benefit to the member (a practice incidentally which was recently confirmed by a joint study by ASIC and the Australian Consumers' Association), will apply to an expanded segment of the workforce. We will continue, to argue that this is not in the interests of working people nor the long; term interests of a successful retirement incomes policy.

Questions on Notice to Industry Super Network and Mr Gary Weaven arising from their appearance at the committee's public hearing in Melbourne on 6 March 2007

The following questions will assist the Committee towards a better understanding of the mutual structure and operations of superannuation funds within the Industry Super Network.

1. Members Equity Bank (MEB) is a significant financial institution
    a. Identify subsidiary companies owned by MEB and describe their business functions and operations

    b. What type of services does MEB provide to industry funds that are members of MEB?

2. Name the industry superannuation funds who are members of Members Equity Bank?

3. Do industry superannuation funds in MEB hold equal interests with the same rights? If not, what are the differences in security holdings and rights thereto?

4. In that context, the submission from Members Equity Bank says it "*is wholly owned by 40 participating industry superannuation funds (ISFs)…*" and that *"ME is currently in the process of merging with Industry Funds Services Pty Ltd (IFS).*"

    However, according to the ASIC database at the time the Committees' public hearings commenced, Industry Funds Services Pty Ltd owned all 4,243,977 shares in Members Equity Bank Pty Ltd.

    Also, according to the ASIC database, the 600 shares in Industry Funds Services Pty Ltd are owned by what appear to be 9 industry super funds.

    Can you explain what, if any, capital reconstructions or transfers have occurred since the last filings with ASIC to expand this ownership to 40 industry super funds, or, otherwise the way in which it has been established that ownership is by 40, rather than 9, participating funds?

    What is the context of 200,000 shares being issued to Industry Funds Services Pty Ltd by ME Bank in May 2006?

5. Do the related party provisions of the Corporations Act 2001 apply to:
    a. MEB:

    b. Trustee shareholders of MEB?

6. Public offer superannuation and non public offer industry funds operate for the benefit of millions of Australians. Why shouldn't the same standards of disclosure and accountability that apply to public companies also apply to industry superannuation fund trustees?

7. The ASIC company registers shows that MEB is a large proprietary company that is not a disclosing entity. Given your stated support for disclosure and transparency, does MEB disclose remuneration of its executive officers?

8. Why has MEB not converted to a public company in view of its stated support for transparency and disclosure?

9. In its provision of services to industry superannuation funds does MEB charge commercial rates?

10. It is understood that Industry Funds Services Pty Ltd (IFS), a diversified financial services company providing financial planning services, funds management services and various other trustee services, was purchased by MEB and its operations absorbed into the operations of the Bank. What was the acquisition cost to the Bank, how was it financed, and what amount was paid to each of the shareholder owners of IFS?

11. During Board discussions about the acquisition of, or merger of ME Bank with Industry Funds Services Pty Ltd, how have Mr Gary Weaven, as a Director of ME Bank and also Executive Chair of Industry Funds Services Pty Ltd and Mr Bernie Fraser as a Director of ME Bank and also of 3 (Australian Super Pty Ltd, United Super Pty Ltd and Australian Retirement Fund Pty Ltd) of the 9 superannuation funds which own Industry Funds Services Pty Ltd dealt with perceived conflicts of interest?

12. What factors led, only 11 days after a story in the Australian Financial Review, referring to controversy surrounding IFS-SET Pty Ltd, to its 75 shares, comprising a 12.5% stake in Industry Funds Services Pty Ltd, being transferred to a number of IFS's existing superannuation fund shareholders?

13. The ASIC filing states that the "*Total $ paid on these shares*" is "*$25,500*" and that this figure is given for all of the transfers, be they for as few as 4 shares or for the whole 75 shares.

    What was the actual consideration paid for these shares?

14. In relation to the acquisition of IFS by MEB, have the details in Section C4 of ASIC Form 484 been corrected to show the "Total $ paid on these shares"?

15. You state in the document provided to the Committee, titled 'Response to Speech of Senator Grant Chapman incorporated in Hansard – 1.56 am, 24 June

2004' that Industry superannuation funds "have been leaders in accountability and disclosure". How can that statement be valid when there has been no disclosure to industry superannuation fund members of related party arrangements or executive remuneration benefits?

16. IFS SET Pty Ltd as the trustee of the Staff Equity Trust did not derive any income. However, what income did the staff, being beneficiaries of the Staff Equity Trust derive through the interests held by IFS SET Pty ltd in IFS?

17. In the speech to the Senate on 24 June 2004, a number of issues were raised to which no response was made in the document provided to the Committee. Please provide a response to the following questions:

    a. What income did DIF-SET (as trustee for the Staff Equity Trust) derive from its extensive involvement in the administration and management of industry fund assets?

    b. What benefits did Mr Weaven and the limited numbers of other beneficiaries of IFS-SET derive from its and their involvement with IFS?

    c. Was the transition from a "diversified financial services company which provided financial planning services, funds management services and various trustee services" to a banking model, a means of restructuring means Mr Weaven and others' interest in this lucrative business? If not, why not?
    d. Following the absorption of IFS within Members Equity, what are the salary packages of Mr Weaven and other individuals, previously with IFS-SET, and now representing Members Equity Bank?

18. What were the retirement benefits paid to the Directors who stood down following the ARF/STA Super Fund Merger?

19. Do financial planners employed by MEB advise on all superannuation funds in the market?

20. Do industry fund financial planners including the financial planning business advisers of MEB, provide limited advice? Has ASIC reviewed the records and practices of industry fund advisers where advice is sought directly or indirectly to switch funds?

21. How does Members Equity Bank provide incentives for its sales, marketing and adviser staff?

22. Do Members Equity Bank sales, marketing and adviser staff have sales targets?

23. What sponsorship or financial support has been given or is intended to be given to ACTU functions and events by IFS Pty Ltd and/or ME Bank?

24. What are the level of prudential reserves of each Industry Super Fund?

25. Do the 2005 and 2006 MEB Annual Reports comply fully with the requirements of the Corporations Act 2001?

26. Balanced funds have three objectives: moderate long-term growth of capital, moderate income and moderate stability. Do all balanced funds have the same risk/return profile? Is a person who is properly advised likely to get higher returns where they direct investments in to higher growth options?

Appendix 5

APRA's 10 years of superannuation statistics

Table 13: Investment choice

Entities with at least $100 million in assets

	June 2004	June 2005	June 2006
All entities			
Number of entities	339	311	276
Number of entities offering investment choice	245	242	221
Proportion of entities offering investment choice	72.3%	77.8%	80.1%
Average number of investment choices offered per entity[a]	29	31	40
Total assets ($bn)	449.7	535.9	646.0
Assets of entities offering investment choice ($bn)	386.2	469.4	583.4
Assets in entities offering investment choice	85.9%	87.6%	90.3%
Assets in default investment strategy ($bn)[b]	286.2	312.2	353.9
Proportion of assets in default strategy	63.6%	58.2%	54.8%
By functional classification			
Corporate			
Number of entities	104	89	69
Number of entities offering investment choice	58	66	52
Proportion of entities offering investment choice	55.8%	74.2%	75.4%
Average number of investment choices offered per entity[a]	6	6	6
Total assets ($bn)	41.8	45.4	48.3
Assets of entities offering investment choice ($bn)	27.3	40.6	43.8
Assets in entities offering investment choice	65.2%	89.3%	90.8%
Assets in default investment strategy ($bn)[b]	22.0	26.5	27.5
Proportion of assets in default strategy	52.6%	58.2%	56.9%
Industry			
Number of entities	68	64	59
Number of entities offering investment choice	59	57	54
Proportion of entities offering investment choice	86.8%	89.1%	91.5%
Average number of investment choices offered per entity[a]	7	8	9
Total assets ($bn)	93.2	118.7	149.7
Assets of entities offering investment choice ($bn)	91.1	117.0	148.4
Assets in entities offering investment choice	97.7%	98.6%	99.2%
Assets in default investment strategy ($bn)[b]	65.0	83.2	110.1
Proportion of assets in default strategy	69.8%	70.1%	73.6%

Excludes ERFs because they do not offer investment choice.

[a] The average number of investment choices offered per entity refers to those entities that have investment choice.

[b] Not all entities are required to have a default investment strategy. Where there is no default strategy, the strategy of the largest option or the fund strategy as a whole is reported.

Table 13: Investment choice (continued)

Entities with at least $100 million in assets

	June 2004	June 2005	June 2006
Public sector			
Number of entities	33	33	32
Number of entities offering investment choice	23	21	23
Proportion of entities offering investment choice	69.7%	63.6%	71.9%
Average number of investment choices offered per entity[a]	5	7	7
Total assets ($bn)	108.8	128.8	151.7
Assets of entities offering investment choice ($bn)	87.0	103.3	136.4
Assets in entities offering investment choice	80.0%	80.2%	89.9%
Assets in default investment strategy ($bn)[b]	80.9	82.4	92.8
Proportion of assets in default strategy	74.3%	64.0%	61.2%
Retail (excluding ERFs)			
Number of entities	127	118	110
Number of entities offering investment choice	105	98	92
Proportion of entities offering investment choice	82.7%	83.1%	83.6%
Average number of investment choices offered per entity[a]	83	88	108
Total assets ($bn)	201.6	238.2	291.4
Assets of entities offering investment choice ($bn)	180.8	208.5	254.8
Assets in entities offering investment choice	89.7%	87.5%	87.5%
Assets in default investment strategy ($bn)[b]	118.3	120.1	123.5
Proportion of assets in default strategy	58.7%	50.4%	42.4%

Excludes ERFs because they do not offer investment choice.

[a] The average number of investment choices offered per entity refers to those entities that have investment choice.

[b] Not all entities are required to have a default investment strategy. Where there is no default strategy, the strategy of the largest option or the fund strategy as a whole is reported.

Table 14: Asset allocation of default investment strategy

Entities with at least $100 million in assets

	June 2004	June 2005	June 2006	June 2004	June 2005	June 2006
		($ million)			Proportion of default strategy assets	
All entities						
Australian shares	88.8	97.0	113.2	31.0%	31.1%	32.0%
International shares	65.2	71.8	86.6	22.8%	23.0%	24.5%
Listed property	9.3	9.5	11.1	3.2%	3.1%	3.1%
Unlisted property	13.2	14.8	19.4	4.6%	4.7%	5.5%
Australian fixed interest	34.5	33.7	34.1	12.1%	10.8%	9.6%
International fixed interest	16.3	18.5	18.9	5.7%	5.9%	5.3%
Cash	22.5	29.5	27.1	7.9%	9.4%	7.6%
Other	36.3	37.5	43.6	12.7%	12.0%	12.3%
Total default strategy assets	286.2	312.2	353.9	100.0%	100.0%	100.0%
Superannuation assets	449.7	535.9	646.0			
By functional classification						
Corporate						
Australian shares	7.6	9.7	10.9	34.6%	36.5%	39.6%
International shares	5.3	6.9	6.9	24.1%	26.0%	24.9%
Listed property	0.6	1.0	0.9	2.8%	3.8%	3.1%
Unlisted property	0.8	0.7	1.0	3.7%	2.7%	3.7%
Australian fixed interest	2.3	3.4	3.7	10.6%	12.9%	13.5%
International fixed interest	1.2	1.6	1.7	5.4%	5.9%	6.2%
Cash	1.1	0.9	1.1	5.1%	3.5%	4.1%
Other	3.0	2.3	1.3	13.5%	8.7%	4.9%
Total default strategy assets	22.0	26.5	27.5	100.0%	100.0%	100.0%
Total assets	41.8	45.4	48.3			
Industry						
Australian shares	22.5	29.6	37.2	34.5%	35.6%	33.8%
International shares	15.4	20.0	28.2	23.6%	24.0%	25.6%
Listed property	2.3	2.5	2.9	3.5%	2.9%	2.6%
Unlisted property	3.9	5.5	8.4	6.0%	6.6%	7.6%
Australian fixed interest	7.7	8.5	10.0	11.9%	10.2%	9.1%
International fixed interest	4.2	4.6	5.1	6.5%	5.6%	4.6%
Cash	3.6	4.4	5.5	5.5%	5.3%	5.0%
Other	5.5	8.2	12.9	8.4%	9.9%	11.7%
Total default strategy assets	65.0	83.2	110.1	100.0%	100.0%	100.0%
Total assets	72.6	93.2	118.7			

Excludes ERFs because they do not offer investment choice.

Not all entities are required to have a default investment strategy. Where there is no default strategy, the strategy of the largest option or the fund strategy as a whole is reported.

Table 14: Asset allocation of default investment strategy (continued)

Entities with at least $100 million in assets

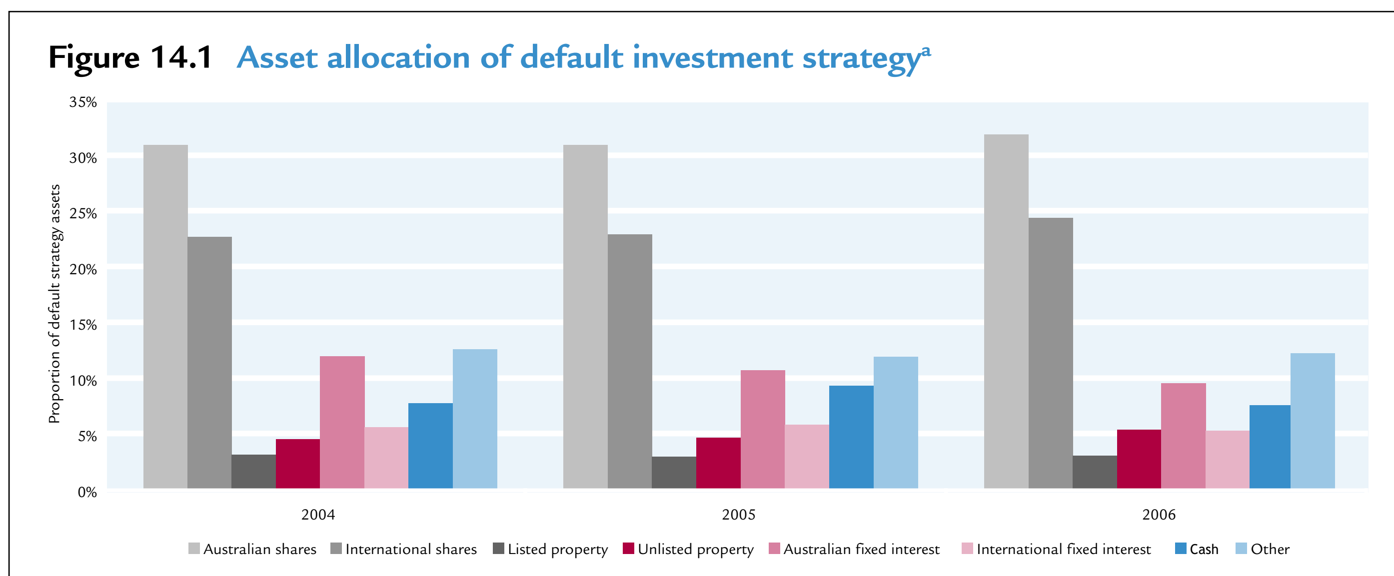
	June 2004	June 2005	June 2006	June 2004	June 2005	June 2006
	($ million)			Proportion of default strategy assets		
Public sector						
Australian shares	26.6	26.2	29.9	32.9%	31.8%	32.2%
International shares	22.6	23.2	25.3	28.0%	28.2%	27.2%
Listed property	2.2	2.4	3.0	2.7%	2.9%	3.2%
Unlisted property	6.0	5.2	6.2	7.4%	6.3%	6.6%
Australian fixed interest	6.7	6.3	6.1	8.3%	7.6%	6.6%
International fixed interest	5.6	7.0	6.1	6.9%	8.5%	6.5%
Cash	6.4	6.8	7.0	7.9%	8.2%	7.6%
Other	4.7	5.3	9.3	5.8%	6.4%	10.0%
Total default strategy assets	80.9	82.4	92.8	100.0%	100.0%	100.0%
Total assets	108.8	128.8	151.7			
Retail (excluding ERFs)						
Australian shares	32.1	31.5	35.2	27.1%	26.3%	28.5%
International shares	21.9	21.7	26.3	18.5%	18.1%	21.3%
Listed property	4.2	3.7	4.4	3.5%	3.1%	3.5%
Unlisted property	2.5	3.4	3.9	2.1%	2.8%	3.1%
Australian fixed interest	17.8	15.5	14.2	15.0%	12.9%	11.5%
International fixed interest	5.3	5.3	6.1	4.4%	4.4%	4.9%
Cash	11.4	17.3	13.4	9.6%	14.4%	10.9%
Other	23.2	21.7	20.0	19.6%	18.0%	16.2%
Total default strategy assets	118.3	120.1	123.5	100.0%	100.0%	100.0%
Total assets	201.6	238.2	291.4			

Excludes ERFs because they do not offer investment choice.

Not all entities are required to have a default investment strategy. Where there is no default strategy, the strategy of the largest option or the fund strategy as a whole is reported.

Statistics Entities with at least $100 million in assets

Figure 14.1 Asset allocation of default investment strategy[a]



[a] Entities with at least $100 million in assets.