INDUSTRY FUNDS FORUM

Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Structure and Operation of the Superannuation Industry

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Thank you for this opportunity to make a submission to the inquiry into the structure and operation of the superannuation industry.

WHO WE REPRESENT

The Industry Funds Forum (IFF) is an incorporated association made up of the Chief Executive Officers of 22 of Australia's largest industry superannuation funds (Industry Funds) (See Attachment).

These Industry Funds include multi-industry and industry-specialist, national and state funds. Collectively members of IFF represent over 8.7 million accounts, 463,000 participating employers and manage over $90.8 billion in retirement benefits[1].

IFF is able to provide a broad cross section of the views and interests of Industry Funds and their members who are representative of average Australians.

WHAT OUR SUBMISSION ADDRESSES

Our Submission focuses on:

- **Best interests of members**: What is in the best interests of the members whose retirement savings are entrusted to Industry Funds to manage with the view to maximising those retirement savings, while still having regard for security and cost.
- **Equity between members:** Reducing and where possible removing, any potential inequities or discrimination between members or groups of members.
- **Highlighting any disadvantages:** Identifying any group that may be disadvantaged by the proposed changes.
- **Avoiding unnecessary complexity:** Identifying obligations the changes will impose on trustees that will create unnecessary complexity and therefore will increase administration costs, which will ultimately result in a reduction of members' retirement savings.

CONTACT DETAILS

Please contact Helen Hewett, IFF Executive Officer on 041 7341235 if you require any further information on this submission or wish to discuss same.

[1] Figures apply as at 30 June 2006

TERMS OF REFERENCE

The Terms of Reference state that the Committee will inquire into the structure and operation of the *Superannuation Industry (Supervision) Act 1993* (SIS) 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 15 specific areas.

Those 15 areas to be investigated are described in minimal terms with no detailed guidance given. This lack of information leaves all 15 areas open to interpretation, and makes the Terms of Reference extremely broad to respond to.

Our response is based on each of the 15 areas identified and we have initially set out what our understanding of each is for clarity.

The 15 terms of reference for this inquiry cover many issues which have been previously investigated and to which the industry has responded at length. There have been significant enhancements to the regulatory environment and raising of standards since some of these issues were last examined. Many of those improvements have occurred as a direct result of those previous investigations and consultation with the industry. This inquiry has provided an opportunity for IFF to reconsider these issues in the context of those changes, and to assess the effectiveness of those changes.

EXECUTIVE SUMMARY

TERM OF REFERENCE NO. 1: WHETHER UNIFORM CAPITAL REQUIREMENTS SHOULD APPLY TO TRUSTEES

IFF opposes any change to the existing rules on capital adequacy for Trustees of superannuation funds.

TERM OF REFERENCE NO. 2: WHETHER ALL TRUSTEES SHOULD BE REQUIRED TO BE PUBLIC COMPANIES

IFF opposes this proposal on the basis that the change in status for those corporate trustees that are not already public companies would not provide a corresponding benefit given the existing level of regulation. It would add to compliance costs of these trustees without any improvement in risk management or performance.

TERM OF REFERENCE NO. 3: THE RELEVANCE OF AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY STANDARDS

IFF welcomes industry consultation on the practical application of the SIS operating standards to identify any changes required.

TERM OF REFERENCE NO. 4: THE ROLE OF ADVICE IN SUPERANNUATION

IFF submits:

- Commissions as they relate to financial advice on superannuation create a fundamental conflict of interest that cannot be managed by disclosure or other means and must be avoided.
- Commissions relating to advice on superannuation guarantee contributions (**SG contributions**) should be banned.
- Financial advisers should be subject to a legislative duty to act in the best interests of their clients.
- Members should be able to use their retirement savings to fund access to appropriate financial advice subject to appropriate safeguards.
- The current definition of general advice is a disincentive to trustees of superannuation funds to provide members with general educational activities, and those restrictions should be removed to facilitate an increase in financial literacy.

TERMS OF REFERENCE NO. 5 AND NO. 6: THE MEANING OF MEMBER INVESTMENT CHOICE AND THE RESPONSIBILITY OF THE TRUSTEE IN A MEMBER INVESTMENT CHOICE SITUATION

IFF submits:

- APRA Superannuation Circular No. II.D.1 (**the Circular**) requires trustee's to assume total responsibility for investment, while simultaneously allowing members to direct the trustee how to investment their moneys. The interpretation given to these two obligations in the Circular is no longer sustainable in the current superannuation environment.
- The obligations of trustees concerning investment of a fund's assets are to make the strategic decisions on whether to offer MIC, and if so what those choices should consist of, the management of those investments including the appointment and monitoring of investment managers, recovery of costs associated with establishment and ongoing management of additional strategies, ensuring liquidity is maintained, and meeting disclosure obligations so members can make informed decisions.
- Further discussion and review of APRA's approach as outlined in its Circular is required.
- Section 1012IA of Corporations Act and ASIC Policy Statement 184 (**PS 184**) should continue to apply subject to the relief given under Class Order 03/1097 indefinitely. In addition Section 1012IA should not apply to underlying investments in:
    - composite investment options where the trustee determines the asset allocation and selects the investment managers;
    - wholesale financial products or Pooled Superannuation Trusts in which a retail client cannot directly invest.

TERM OF REFERENCE NO. 7: THE REASONS FOR THE GROWTH IN SELF MANAGED SUPERANNUATION FUNDS

IFF submits:

- Trustees of these funds should be required to have an appropriate level of understanding of their obligations as trustees in the same way as other trustees. Appropriate training and fit and proper requirements should be imposed.
- Legislation and regulation of this sector should be strengthened to ensure that SMSFs are used for the accumulation of retirement savings and not to pursue other business interests.
- Data on the performance and cost of SMSFs should be available to consumers considering establishing an SMSF so they can compare this option with what is offered by other superannuation funds.

TERM OF REFERENCE NO. 8: THE DEMISE OF DEFINED BENEFIT FUNDS AND THE USE OF ACCUMULATION FUNDS AS THE INDUSTRY STANDARD FUND

IFF recognises the importance of ensuring that defined benefit funds are adequately regulated and managed, that members' accrued defined benefits are protected and that they are appropriately funded.

TERM OF REFERENCE NO. 9: COST OF COMPLIANCE

IFF submits:

- Dual regulation and licensing of superannuation funds should be removed in favour of a single regulator.
- Trustees should only be required to notify one regulator of a material breach under the breach reporting obligations for APRA and ASIC.
- The level of detailed information required in a PDS and under S 1013E of the Corporations Act, and the lack of clarity about its limits reduces its effectiveness and increases the cost in producing it.
- The operation of Section 1012IA of the Corporations Act referred to in our submission on terms of reference 5 and 6 above adds to the complexity without adding value for the consumer.
- Lack of financial literacy and access to financial advice should be the focus of Government initiatives in this area.

TERM OF REFERENCE NO. 10: THE APPROPRIATENESS OF THE FUNDING ARRANGEMENTS FOR PRUDENTIAL REGULATION

IFF submits:

- Cross subsidies should be removed from the calculation of the Supervision Levy.
- The Supervision Levy should be determined according to risk and not the size of the fund.
- Adequate professional indemnity and fidelity insurance should be mandatory for all trustees

TERM OF REFERENCE NO. 11: WHETHER PROMOTIONAL ADVERTISING SHOULD BE A COST TO A FUND AND, THEREFORE, TO ITS MEMBERS

IFF submits:

- The cost of advertising is a legitimate expense of a superannuation fund like any other administration or operational expense and there is no justification for treating it differently.
- The primary objective of Industry Fund expenditure on advertising is retention of members and funds under management (**FUM**).
- Retention of member numbers and FUM is essential to maintain economies of scale, which in turn provides access to competitive management and administration fees, which is in the best interests of members.
- Members pay all advertising costs directly or indirectly regardless of a fund's business model.
- Fund choice is based on an informed market and a level playing field for all participants in that market. Requiring "all profits to members" funds to fund the cost of advertising from resources external to fund assets effectively operates as a ban on those funds advertising, as they do not hold other financial resources.

- An inevitable consequence of such a ban would be a significant reduction of competition in the industry.

TERM OF REFERENCE NO. 12: THE MEANING OF THE CONCEPTS "NOT-FOR-PROFIT" AND "ALL PROFITS GO TO MEMBERS"

These terms are commonly understood and are based on the operation of the trustee.

TERM OF REFERENCE NO. 13: BENCHMARKING AUSTRALIA AGAINST INTERNATIONAL PRACTICE AND EXPERIENCE

The three-pillar Australian retirement income system is recognised internationally as World-Class. Australia is a World leader and our system is a model for other countries.

TERM OF REFERENCE NO. 14: LEVEL OF COMPENSATION IN THE EVENT OF THEFT, FRAUD AND EMPLOYER INSOLVENCY

IFF submits:

- all members of regulated superannuation funds must be protected against loss of their retirement income as a result of theft, fraud and employer insolvency.
- Mandatory professional indemnity and fidelity insurance by trustees should be legislated.
- Superannuation levies should be based on account balance rather than fund size to avoid an unfair burden falling on members with low account balances.
- SG contributions should be paid monthly to reduce risk and trustees should be given legislative support to actively pursue arrears of contributions.

TERM OF REFERENCE NO. 15: ANY OTHER RELEVANT MATTERS

Matters referred to are as follows:

- The present SG threshold of $450 should be removed.
- Trustees should proactively facilitate consolidation of members' accounts, a centralised ERF managed by the Government should be established to receive all lost member accounts.
- Fund mergers should not trigger a CGT liability.

IFF SUBMISSION ON TERMS OF REFERENCE

1. WHETHER UNIFORM CAPITAL REQUIREMENTS SHOULD APPLY TO TRUSTEES (TERM OF REFERENCE NO. 1)

Our understanding of this term of reference:
It seeks to re-open the debate on whether to impose capital adequacy requirements on all trustees of superannuation funds. We have assumed that this would involve:

- the introduction of a new capital requirement; or
- modifying the current requirements to remove the option of satisfying the requirement by an approved guarantee or under custodial arrangements.

Our position:
IFF opposes any change to the existing rules on capital adequacy for Trustees of superannuation funds.

1.1 Previous Inquiries

This issue was addressed in IFF's submission to the Superannuation Working Group on the Federal Government's "*Options for Improving the Safety of Superannuation*" (**Super Safety Inquiry**) in January 2002. In that submission IFF supported a universal licensing regime for trustee entities based on competence and not access to capital. This issue was central to the Super Safety Inquiry and although minimum capital requirements were recommended by that inquiry, the Government rejected that recommendation. IFF continues to support the decision made by the Government at that time.

APRA licensing for registrable trustee entities (**RSE**) resulted from the Super Safety Inquiry and has substantially increased regulation of the superannuation industry and heightened the safeguards within which it must operate. This has lead to a major rationalisation of the industry. IFF submits that this new regulatory environment adequately addresses this issue. Consequently IFF opposes any change to the existing rules on capital adequacy for Trustees of superannuation funds because they would be unnecessary and inappropriate for the following reasons.

1.2 Current Capital Adequacy Requirements

To meet the capital requirements APRA must be satisfied that an RSE licensee:

- holds net tangible assets (**NTA**) equal to or greater than $5m;
- has the benefit of an approved guarantee equal to or greater than $5m relating to its duties as trustee of each RSE of which it is a trustee;
- has the benefit of an approved guarantee as above and the amount of that approved guarantee and its NTA are equal to or greater than $5m; or
- has a written agreement concerning custody of assets of each RSE of which it is a trustee.[2]

[2] Section 29DA SIS and Regulation 3A.04 SIS Regulations

APRA has advised that the NTA requirements have a threefold purpose:

- they provide some financial resources to act as a buffer against risk;
- they evidence a commitment on the part of a trustee to its superannuation business; and
- they act as an incentive to the trustee to manage the entity well.[3]

This is based on the statement in the Explanatory Memorandum to the SIS legislation that to be an Approved Trustee an applicant had to satisfy the Commissioner that it could perform trustee duties in a proper manner and also have access to "sufficient financial resources (*or suitable custody arrangements have been put in place*) to provide appropriate security to beneficiaries of a relevant entity".

1.3 Use of a Custodian

Custodial arrangements are an effective substitution for the regulatory requirement that otherwise compels Trustees to have a minimum of $5 million in net tangible assets (**NTA**).

Effective custodial arrangements provide far greater and more practical protection against fraud or misdealing than capital adequacy in its own right. The interposition of a custodian reduces the opportunity for errant behaviour or exposure to fund manager insolvency. This is because the custodian retains the legal title to the assets (on behalf of the superannuation fund) at all times. The custodian acts as a 'bare trustee', and fund assets are not intermingled with those of the custodian or any other party.

In the same way, custody reduces the risk of self-dealing by fraudulent or corrupt trustee directors as strict rules apply to the transfer of assets under custody. Unusual transactions would normally be monitored and reported through to the board of the trustee entity. A core competency of custodians involves the monitoring of portfolio concentration and undue exposure to third party risk. Provided an appropriate investment policy and mandate is in place, a well-resourced custodian provides effective supervision and a 'deep pocket' in the event of difficulty. This obviates the need for a trustee entity to have capital that would otherwise 'cushion' the effect of misdealing, the so-called 'comfort money' effect.

1.4 Comparison to Other Financial Services and Product Providers

Superannuation funds are highly regulated trusts that hold only the legal title to assets for the benefit of beneficiaries. A superannuation fund's very essence is that it invests on behalf of others, not on its own account. The 'sole purpose' test[4] limits the activities of trustees to services related to the provision of retirement income. They do not trade on their 'own' and are subject to a number of prohibitions, which further reduce risk of insolvency including prohibitions on:

- borrowing (except in extremely limited circumstances)[5];
- lending to members[6];

[3] Paragraph 4 of Superannuation guidance note SGN 150.1, Capital requirements – net tangible assets.

[4] SIS, section 62

[5] Section 67 SIS Act

[6] Section 65 SIS Act

- acquiring assets from members[7], and
- placing a charge over, or in relation to, an asset of the fund unless specifically permitted under the SIS Act[8].

There are also restrictions on the level of in house assets[9] a fund can hold and on use of derivatives[10].

Consequently superannuation funds should not be singled out to fit into a prudential framework designed for banks and insurers.

Banks are rightly subject to stringent supervision of the full parameters of risks involved in the business of transforming deposits into loans that may not be recovered. In banking and insurance the principal purpose of capital adequacy is to guard against systemic risks and contagion, primarily borne from credit risk. There is no evidence that fund failure poses any systemic risk to the Australian financial system.

Most superannuation funds are not exposed to credit risk at all. The following analysis of the main risk areas further demonstrates the inappropriateness of applying to superannuation funds the risk management strategies applicable to banks and insurers.

1.5 Credit Risk

Financial insolvency is one of the lowest risks faced by superannuation funds. Credit risk exists only amongst defined benefit funds[11], where employer failure can leave a shortfall in the funding of member benefits. An extensive array of solvency rules within SIS address those risks. However, the assets of a defined contribution super fund (i.e. also referred to as accumulation funds, where the member bears the investment risk) match its liabilities, eliminating credit risk.

1.6 Contagion Risk

The phenomenon of contagion risk (e.g. bank runs) is much smaller in the superannuation environment as the preservation rules prevent members from withdrawing their superannuation benefits for the purpose of investment outside of the superannuation industry. Each member bears the investment risk where a run compromises a fund's liquidity.

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[7] Section 66 SIS Act

[8] Regulation 13.15 SIS Regulations – an exception is a charge in relation to a derivatives contract which is subject to restrictions (*regulation 13.15A*)

[9] Part 8 of SIS Act deal with the in house asset rules. The basic meaning of "in house asset" is an asset of the fund that is a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between a trustee of the fun and a related party of the fund (Section 71). Exceptions apply.

[10] See Superannuation Circular No. II.D.7, Derivatives

[11] The employer sponsor of a defined benefit fund bears the investment risk and the solvency of these funds is subject to stringent requirements under the SIS Act including regular actuarial reviews.

There are low levels of customer churn in superannuation in Australia compared to other countries[12] even after the introduction of fund choice[13]. IFF does not accept that individual fund failure could create an externality for the entire superannuation industry, such that would warrant regulatory intervention.

1.7 Operational Risk

Operational risk can be defined as "the risk of loss as a result of inadequate or failed internal processes, people and systems or from external events". This would include:

- risk of error or failure in the administrative procedures of the business;
- risk related to error or failure of technology;
- risk of fraud;
- compliance risk, including penalties associated with failure to meet legislative requirements; and
- legal risk associated with the many contractual arrangements entered into by a superannuation fund.

All of the above risks are addressed under the requirements for RSE licences discussed in detail below.

1.8 Systemic Risk

In banking and insurance, capital provisioning for operational risk is still firmly directed at guarding against systemic risk. Given that systemic risk is largely absent in superannuation, it is arguable whether capital controls serve any useful purpose in diminishing the actual operational risks faced by superannuation funds.

1.9 Administration and Technology Risks

Capital adequacy would seem an inappropriate tool with which to manage administration and technology risks. There was never any suggestion about capital inadequacy of trustee entities in APRA's detailed examination of "Year 2000" risk during 1999.

Certainly there is no evidence that superannuation funds are managing technology risks poorly or endangering investors' funds as a result. The key competency to guard against operational risk is competency in the management of contractual risk, rather than capital adequacy. This has been acknowledged in the SIS requirements for RSE licensing, which require RSE licensees to have comprehensive risk management strategies and each superannuation fund to have a risk management plan, which comply with SIS and the APRA Guidelines. This includes maintaining a business continuity plan and ensuring that service providers responsible for outsourced activities also have business continuity plans.

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[12] See for example the Chilean experience in Bateman, Piggott, Valdes, '*Australia y Chile: Prevision Privada con Normas Diferentes Comparacion de Regulaciones y de Comisiones e Administracion',* Instituto de Economia, Universidad de Catolica de Chile

[13] ASFA "The introduction of choice of superannuation fund – results to date" February 2006

Provided appropriate business continuity systems are in place, and a competitive market for administration services exists, investors' funds would be safe despite IT failure. Regulatory interest in technology risk should therefore focus on business continuity issues and not the operator's 'market' risk of incurring loss through poor contractual management.

A competitive market (for superannuation and ancillary services) provides the best insurance against technology risk. In the event that an in-sourced or outsourced *administration system malfunctions, there would be any number of companies willing to take on the task. The licensing condition that requires Trustees relying on the custodial concession to have a minimum of $100,000 in liquid assets[14] provides a minimum liquidity standard so that third parties have a minimum comfort level in the event that a trustee runs in to technical difficulty.*

1.10 The Key Point for APRA Licensing

The issues around capital adequacy were a key rationale in the introduction of standards applied in the RSE licensing regime introduced by APRA following an extensive review of this and other issues in the Super Safety Inquiry.

A large number of funds did not obtain an APRA licence and APRA has confirmed that the licensing process has been effective in improving the quality of trustees operating superannuation funds.

IFF submits that the SIS requirements to hold an RSE Licence already adequately address all of the above risks. Part 3 of the SIS Act provides for a system of prescribed standards applicable to the operation of regulated superannuation funds. The legislation amending the SIS Act to introduce RSE licensing expanded Part 3 to allow prescription of standards applicable to trustees and RSE licensees of superannuation funds and trusts to include the following:

- **Fit and Proper**

  The fit and proper standard ensures superannuation funds are managed and overseen competently by honest and trustworthy individuals.[15]

- **Risk Management**

  The SIS Act requires an RSE licensee to have a risk management strategy (**RMS**)[16] which complies with the requirements in Section 29H of the SIS Act.[17]. That section requires the RMS to contain reasonable measures and procedures to identify, monitor and manage risks, including:

  - risks concerning governance and decision-making processes;
  - risks associated with outsourcing arrangements;

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[14] Where administration is in house this amount increases to $250,000 but may be higher depending on the nature of the trustee's activities (*See APRA FAQ 9.1 Adequacy of Financial Resources*).

[15] Section 31(2)(ma) of SIS Act, SIS Regulation 4.14 and APRA Superannuation guidance note SGN 110.1 – Fit and Proper.

[16] Division 8 of Part 2A of the SIS Act

[17] See also APRA Superannuation guidance note SGN 120.1 – Risk Management.

- risks arising from changes in legislation applicable to an RSE licensee; and
- risks of potential fraud and theft.

The RMS must remain up to date and be reviewed at least once a year.

In addition regulations[18] require all material risks[19] to be addressed in the RMS, including an assessment of the likelihood and consequences of each material risk, how those risks will be treated and what residual risk remains.

In addition to the RMS each registrable superannuation entity of the trustee must have its on risk management plan.[20]

- **Outsourcing**

  This operating standard applies to material outsourcing agreements, being those agreements or arrangements for performance of a material business[21] activity of a trustee and sets out requirements for those arrangements.[22]

  The operating standard covers all aspects of the outsourcing arrangement from the terms of the contract through to ongoing monitoring, auditing and reporting obligations. Any agreement with a service provider to which the standard applies must include details of a business continuity plan that addresses system breakdowns, power failure etc. to ensure service levels are maintained.

- **Adequacy of Resources**

  The adequacy of resources standard ensures that an RSE licensee has, or has available to it through its outsourced arrangements, adequate resources to undertake its licensed activities. This includes the adequacy of financial, technical and human resources.[23] What is adequate varies according to the type, size and complexity of the business.

1.11 Impact on "all profits to members" Funds

In the event that a fixed capital requirement was introduced, trustees of "all profits to members" funds would, if able to do so, be forced to build capital reserves through member subscription or increasing fee income. It would therefore be counter productive for members to fund the capital 'at risk' for their own protection.

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[18] SIS Regulation 4.07A

[19] Material risks are those with the potential to adversely affect the interests of members or beneficiaries of the superannuation fund or have a significant impact on the business operations, reputation, rate of return, profitability, or net assets of the trustee.

[20] Section 29L(2)(e) and Division 5 of Part 2B of the SIS Act.

[21] A "material business activity" is a business activity that has the potential if disrupted or poorly performed, to affect members' or beneficiaries' interests, or to have a significant impact on the business operations, reputation, rate of return, profitability or net assets of the fund or the trustee (*SIS Regulation 4.16(1)*)

[22] Section 31(2)(sa) SIS Act, SIS Regulation 4.17 and APRA Superannuation guidance note SGN 130.1 – Outsourcing

[23] Section 31(2)(sb) SIS Act, regulation 4.15 SIS Regulations and APRA Superannuation guidance note SGN 140.1 – Adequacy of resources

Any change to the capital adequacy requirements would have a significant impact on the "all profits to members" funds sector of the Superannuation Industry compared to commercial funds.

This is because it is difficult for superannuation funds that are not operated on a profit to shareholder basis, to meet increased capital requirements without altering their status. In addition these funds are not conglomerates involved in multiple business activities. Their sole purpose for existing is to establish, manage and operate a not for profit superannuation fund for the benefit of their members.

The proposal *would therefore lead to inequity in how different parts of the industry are treated which in turn could lead to a reduction to competition, which would be counter productive to the Government's own policy objectives. The ultimate losers would be the members of Industry Funds, which have been major contributors to the growth of superannuation in this country by increasing competition and driving change across the industry for the benefit of members.*

1.12 Effectiveness of Capital Adequacy as a Risk Management Tool

As a compensation measure or as an instrument to minimise operational risk, IFF submits that capital adequacy is totally ineffective. Trustee entities would be required to hold very sizeable amounts in order to provide effective protection.

1.13 Disadvantages of Introducing Uniform Capital Requirements

There are several potential disadvantages to introducing uniform capital requirements:

- Reducing competition given that:
  - many 'all profits to members' funds will be prevented from raising capital within the existing terms of their schemes; and
  - existing shareholders may be unwilling or unable to contribute further capital.
- Raising the overall price of providing superannuation (serving the significant opportunity cost of regulated capital).
- Serving as an external catalyst for a major restructure of the superannuation industry in favour of commercial funds.

1.14 APRA's Position

APRA has stated that its important for a Trustee to have access to capital in times of financial stress. APRA's Superannuation Guidance Note SGN 150.1, on Capital Requirements states that the minimum requirements for net tangible assets (**NTA**) acts as "a buffer against risk; they evidence a commitment on the part of a trustee to its superannuation business; and they act as an incentive to the trustee to manage the entity well"[24]. For the reasons outlined above IFF submits that the "buffer against risk" and a demonstration of a trustee's commitment to manage the fund well can be adequately achieved through the mechanisms provided under the current regulatory provisions.

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[24] Referred to in Paragraph 4 of Guidance Note 150.1 quoting from the explanatory memorandum to the SIS Legislation.

These are currently addressed through APRA licensing, the risk rating system applied to funds by APRA following their regular review; Corporations Law, which imposes obligations on directors of corporate trustees including those in relation to solvency and professional indemnity insurance. These could be strengthened by the introduction of mandatory levels of fidelity insurance to protect against fraud.

Most professional indemnity insurance policies held by trustees include fidelity insurance. This type of insurance would cover risks like errors in the crediting rate or unit pricing, theft, fraud and mismanagement.

1.15 Recommendations

IFF recommends:

- that the existing capital adequacy rules be retained; and
- that maintaining adequate fidelity insurance be made a mandatory requirement for trustees of superannuation funds.

2. WHETHER ALL TRUSTEES SHOULD BE REQUIRED TO BE PUBLIC COMPANIES (TERM OF REFERENCE NO. 2)

Our understanding of this term of reference:
That the additional obligations under the Corporations Act applicable to public companies would apply to all corporate trustees of superannuation funds in addition to the existing obligations under SIS and the Corporations Law.

Our position:
IFF opposes this proposal on the basis that the change in status for those corporate trustees that are not already public companies would not provide a corresponding benefit given the existing level of regulation. It would add to compliance costs of these trustees without any improvement in risk management or performance.

Very few Trustees are public companies. Generally most Trustees are already complying with many of the requirements of public companies such as the extensive audit requirements. However some Industry Funds whose trustees are not public companies are concerned about the increased work and cost of becoming a public company and as such being required to comply with all requirements.

2.1 Appointment of Directors

Directors of a public company must be appointed by separate resolution unless there is unanimous agreement to one resolution.[25] A Corporate Trustee of a non-public offer fund must comply with the equal representation rules or the alternative agreed representation rule under SIS[26].

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[25] Section 201E Corporations Act

[26] Section 91(4) and 92(5) SIS

This means the directors will consist of equal numbers of employer appointed directors and member elected directors, or if the alternative agreed representation rule applies, directors will be appointed by a majority of members of the fund and the employer sponsors.

2.2 Removal of Directors

Shareholders of a public company have a right to remove directors by ordinary resolution of shareholders[27].

SIS specifies the circumstances in which a member representative director can be removed. Removal can only be by the same procedure by which they are appointed, except in the case of death, mental or physical incapacity, on becoming a disqualified person, resignation, expiration of the term of their appointment or on ceasing to satisfy a condition of eligibility for appointment (e.g. if they ceased to meet the fit and proper requirements)[28].

2.3 Governance and Financial Management

There appears to be no significant difference in terms of governance and financial management between public and private companies.

2.4 Change to Public Company No Improvement

Understandably, the governance requirements under the Corporations Act for a proprietary company are not as strict as those for a public Company. However, in the case of corporate trustees of superannuation funds this needs to be considered in the context of all the other regulatory requirements that apply under SIS and the Corporations Act.

Corporate trustees are subject to significant prudential regulation by APRA under SIS and its regulations, and must comply with requirements attaching to both APRA and, in many cases, to AFS Licences. A trustee is also subject to an obligation under SIS to act in the best interests of members. A move to public rather than proprietary status therefore adds little substance to the existing regulatory position and may create duplication and conflicts between the two requirements. In particular disclosure under the Corporations Act is dealt with extensively. This is disclosure relevant to the funds themselves rather than to the trustee entities. In the case of Industry Funds, which hold no assets in their own right, disclosure at the fund level is important from a consumer protection viewpoint.

2.5 Recommendations

IFF recommends that there be no change in status for corporate trustees that are not already public companies.

[27] Section 203D Corporations Act

[28] Section 107(2)(a)(ii) SIS and 4.06 of SIS Regulations

3. THE RELEVANCE OF AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY STANDARDS (TERM OF REFERENCE NO. 3)

Our understanding of this term of reference:
We have assumed that this term of reference relates to the SIS operating standards and their effectiveness in the prudential regulation of superannuation funds.

Our position:
IFF welcomes industry consultation on the practical application of the SIS operating standards to identify any changes required.

Section 31(1) of SIS allows standards to be prescribed by regulations that apply to the operation of regulated superannuation funds and to trustees and RSE licensees of those funds.

What those standards can include is outlined in Section 31(2) but is not limited to those specific areas. Trustees must ensure that the prescribed standards applicable to the operation of their fund are complied with at all times. Intentionally or recklessly contravening this requirement is an offence punishable on conviction by a fine.[29]

IFF would welcome industry consultation on the practical application of standards. Such a process could help identify any changes required.

4. THE ROLE OF ADVICE IN SUPERANNUATION (TERM OF REFERENCE NO. 4)

Our understanding of this term of reference:
IFF understands this term of reference to relate to:

- the quality and adequacy of financial advice on superannuation issues;
- the effect of commission and adviser remuneration on that advice;
- the impact of conflicts of interest on that advice; and
- the use of superannuation savings to fund financial advice.

Our position:

- Commissions as they relate to financial advice on superannuation create a fundamental conflict of interest that cannot be managed by disclosure or other means and must be avoided.
- Commissions relating to advice on superannuation guarantee contributions (SG contributions) should be banned.
- Financial advisers should be subject to a legislative duty to act in the best interests of their clients.
- Members should be able to use their retirement savings to fund access to appropriate financial advice subject to appropriate safeguards.
- the current definition of general advice is a disincentive to trustees of superannuation funds to provide members with general educational activities, and those restrictions should be removed to facilitate an increase in financial literacy.

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[29] Section 34(2) SIS

This issue was addressed in IFF's submission on the "Plan to Simplify and Streamline Superannuation" in response to the proposed changes announced in the Federal Budget on 9 May 2006.

4.1 Results of ASIC Shadow Shopping

In late 2004 and early 2005 ASIC undertook surveillance of financial advisers to test compliance with disclosure obligations, costs, possible loss of benefits and other significant consequences as a result of advice to switch superannuation funds. The results of that surveillance were set out in a report to the Parliamentary Joint Committee dated 9 November 2005 (**the 2005 Report**). In summary the 2005 Report contained the following findings:

- Majority of advisers who recommended a switch made limited or no investigation of the existing fund they advised clients to switch out of.
- Consequently they failed to adequately disclose to clients details of costs, loss of benefits and other significant consequences that would result from following the advice.
- There was a strong tendency for advisers to recommend clients to switch to a fund related to the licensee, which gave rise to a conflict of interest that needed to be carefully managed.

In April 2006 ASIC released a report entitled "Shadow shopping survey on superannuation advice" (**the 2006 Report**). The purpose of the survey was to assess advice given to consumers following the introduction of superannuation choice. The survey identified several key problem areas some of which reflect the findings of the 2005 Report suggesting that little improvement had been achieved in these areas in the intervening period. The key problems identified in the 2006 Report included the following:

- Where consumers were advised to switch funds, a third of this advice lacked credible reasons and risked leaving the consumer worse off. Where a switch was recommended 62% of advisers recommended a higher fee fund, while only 22% recommended a fund with lower fees. In other cases no regard was given to loss of insurance cover or the difference in the cost of insurance or cover on switching.
- Unreasonable advice was 3 to 6 times more common where the adviser had an actual conflict of interest over remuneration (e.g. commissions) or recommending associated products. In 48% of cases dealing with a licensed adviser the advice involved an actual conflict of interest based on the adviser remuneration, and in 38% of cases the advice involved an actual conflict of interest around a fund associated with the licensee. In most cases both of these conflicts existed.[30]
- Non-compliant advice was 3 times more likely where the adviser recommended an associated product.
- Consumers were rarely able to detect bad advice. In cases where ASIC determined the advice clearly lacked a reasonable basis 85% of consumers still felt satisfied with that advice. Even where a Statement of Advice (**SOA**) was provided that disclosed the adviser's conflicts of interest not all consumers were able to adequately judge whether the conflicts had influenced the advice and were not readily able to appreciate the impact of that conflict on the quality of the advice.

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[30] Page 26 2006 Report

- In 46% of cases advisers failed to give a written Statement of Advice where one was required.

On page 12 of the 2006 Report ASIC states:

> "*While disclosure is a critical part of consumer protection, this survey suggests that it can only play a limited role in protecting consumers from inappropriate or conflicted advice.*"

4.2 Conflict Between Independent Advice and Commissions

The mechanisms for managing conflicts of interest are:

- controlling the conflicts of interest;
- disclosing conflicts of interest; or
- avoiding the conflicts of interest.31

Where conflicts cannot be managed by control or disclosure, they must be avoided.[32] Some conflicts of interest by their very nature are so fundamental, or involve the potential for such serious consequences for a client, that the only way to adequately deal with them is to avoid them. In such cases merely disclosing them and imposing internal controls will be inadequate.[33]

ASIC states in the 2006 Report:

> "*Managing conflicts of interest*
>
> *It is clear from the survey that there was a higher risk of inappropriate advice where either the adviser received commission-based remuneration or the adviser recommended a product from an associated company. Licensees and advisers have traditionally relied heavily on disclosure to manage these conflicts. However, disclosure (even where comprehensible) is not, by itself, always an adequate response if the conflict still leads to advice that is in appropriate or compromises the client's interest."*[34]

Payment of commissions in these circumstances represents such a fundamental conflict that it cannot be managed by disclosure or any other means, except avoidance.

Although financial planners are required by law to meet certain requirements under the Corporations Law we are constantly seeing examples where those obligations are being breached across the financial services industry.

Although ASIC is actively investigating these issues it appears to be struggling against what is an entrenched practice. Quite simply 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.

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[31] Para. PS 181.20 of ASIC Policy Statement 181, Licensing: Managing Conflicts of Interest (**PS 181**).

[32] Para. PS 181.37 of ASIC PS 181

[33] Para. PS 181.42 of ASIC PS 181

[34] Page 13 2006 Report

IFF makes the following recommendations:

- The payment of commissions or soft dollar arrangements should be barred in relation to SG contributions.
- All financial advisers should be subject to a duty to act in the best interest of their clients by law. This is the same standard of care imposed on a trustee.

4.3 Sole Purpose Test Restrictions

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.

4.4 Using Superannuation Savings to Pay for Financial Advice

The main barrier for many people, particularly those on lower incomes, to accessing financial advice is the need to pay up front for that advice. It can also be difficult to find financial advisers prepared to accept clients with small amounts of money to invest, like most members of Industry Funds.

This barrier can be overcome to some extent by allowing members access to their superannuation savings to fund appropriate financial advice, so that they can plan their retirement savings strategy.

Access to financial advice even on basic issues like eligibility for the Government's co-contribution, salary sacrificing contributions and investment choice allows those on a low income to significantly increase their retirement savings.

Typically fund experience shows that no access to financial advice leads to poor investment choices and sub-optimal returns. A common example of this is where young members invest too conservatively, while older members invest aggressively to increase savings prior to retirement.

While IFF supports members being able to access their superannuation savings for this purpose it must be subject to appropriate protections, including all financial advice being provided on a fee for service basis with no commission being able to be charged for such service.

A number of funds have allowed, or are considering allowing, members access to their superannuation funds to pay for financial advice relating to superannuation. 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).

Consumers with commission-based superannuation are effectively deducting the cost of advice from their superannuation savings including mandatory contributions, as most of these products include advice as part of the commission.

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.

4.5 Role of Education

It is clear from the above that although we constantly recommend members to seek financial advice that many of them would be better off without it, because of the:

- lack of certainty in the quality of the advice available due in part to the negative influence of commission based remuneration of the planners;
- the limited product range approved by some advisers; and
- the conflicts of interest that exist in the provision of that advice.

Education has an important role but is no substitute for appropriate financial advice. Both are equally important.

Most members need advice at some time for example if they are made redundant, nearing or at retirement. Members do not generally exercise investment choice even though many are offered it through their superannuation fund.

This results in members being in the default investment strategy, which may be unsuitable for them, being under insured; failing to make additional contributions or not contributing at the level needed; or in the most appropriate way (i.e. before or after tax).

4.6 General Advice

(a) Review Definition of "general advice"

IFF submits that consideration should be given to narrowing the scope of general advice to avoid the licensing and disclosure requirements for general advice applying to educational activities conducted by superannuation funds for the benefit of their members.

The definition of general advice is extremely broad and includes any financial product advice that is not personal advice. The definition of financial product advice includes recommendations, statements of opinion or reports of either of those things, intended to influence a person in making a decision about a financial product.

(b) Need for AFS Licence

For a trustee of a superannuation fund to give general advice, it must hold an Australian Financial Services Licence (**AFS Licence**) permitting it to give general advice. The requirements for obtaining and retaining an AFS Licence are quite onerous.

As a result of this very restrictive approach to giving general advice and the need to hold an AFS Licence fewer people are prepared to offer general advice through general educational seminars. This detracts from the Government's initiatives to improve financial literacy in the Australian community.[35]

Attempts have already been made to address this problem. Amendments to legislation have narrowed the scope of general advice, which allow a trustee of a superannuation fund to give advice to members about its own products without it being treated as financial advice. In addition ASIC has clarified how it interprets the law so that merely possessing information about a member's personal circumstances will not mean that advice given to that member will automatically be deemed personal advice.

Despite these changes IFF submits that there is still potential for improving this area of regulation. Treasury conducted the Corporate and Financial Services Regulation Review, in April 2006 as a Consultation Paper (**the Review**). The Review identified the following areas for further discussion concerning the scope of general advice:

(i) the boundaries established of where financial advice begins which in turn imposes onerous training and licensing obligations on the provider of the advice; and

(ii) whether the divide between general and personal advice should be moved to limit when advice should be treated as personal advice in order to avoid the resulting licensing and disclosure obligations.

The following statement appears in the Review:

> *"There is scope to consider how the boundaries of what constitutes general advice could be* adjusted *so as to avoid licensing and disclosure requirements for general educational activities and how this relates to the scope of personal advice."*[36]

The public response to the Governments financial literacy campaign is also an indication of the demand that exists for education in this area. In its media release of 7 September 2006 the Financial Literacy Foundation confirmed that its website has met a need with the community with almost 100,000 individual visits to the website over a 5 week period. The media release includes a statement by Paul Clitheroe as follows:

> "People are telling us that the website provides a much-needed source of *independent financial information and support; it is giving people confidence and empowering them to confidently question financial advisers."*

IFF submits that:

- the onerous requirements of giving advice (e.g. disclosure obligations including provision of a financial services guide and other licensing obligations) should be confined to personal advice;
- the boundary between what is personal advice and what is general advice should be more clearly defined; and

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[35] Paragraph 1.17 of the "Corporate and Financial Services Regulation Review, Consultation Paper, April 2006

[36] Pare 20, paragraph 1.17 of the Review.

- the definition of general advice should be redefined to exempt general educational activities provided by superannuation funds for the benefit of their members to assist them in understanding issues relating to their benefits in the fund and their retirement savings generally.

4.7 Recommendations

SIS should be amended to permit an amount (subject to a cap of $500) to be withdrawn from a member's account per annum to fund financial advice, from an adviser approved by the fund. All advice should be on a fee for service basis only, so that no commissions are involved. A written authorisation from the member to withdraw funds for this purpose must be a prerequisite.

- Legislation should prohibit payment of commissions concerning compulsory superannuation contributions (i.e. mandated contributions). This would help resolve the major issues that give rise to conflicts of interest.
- In general IFF supports the current regime regulated by ASIC and the requirement that all providers of advice must maintain an AFS Licence covering the activities of the adviser. However, members need education and guidance so that they can make active choices to maximise the benefits offered by their superannuation fund and their retirement income. The current AFS regime does not cater for this and should be amended to remove restrictions on the provision by trustees of education material to members.

5. THE MEANING OF MEMBER INVESTMENT CHOICE AND THE RESPONSIBILITY OF THE TRUSTEE IN A MEMBER INVESTMENT CHOICE SITUATION (TERMS OF REFERENCE NOS. 5 AND 6)

Our understanding of these terms of reference:

- How the concept of member investment choice (MIC) and the trustee obligations apply at law.
- The level of responsibility to be assumed by a trustee compared to that of a member where MIC is available.

Our position:

- APRA Superannuation Circular No. II.D.1 (the Circular) requires trustee's to assume total responsibility for investment, while simultaneously allowing members to direct the trustee how to investment their moneys. The interpretation given to these two obligations in the Circular is no longer sustainable in the current superannuation environment.
- The obligations of trustees concerning investments of a fund's assets are to make the strategic decisions on whether to offer MIC, and if so what those choices should consist of, the management of those investments including the appointment and monitoring of investment managers, recovery of costs, ensuring solvency and liquidity and meeting disclosure obligations so members can make informed decisions.
- Further discussion and review of APRA's approach as outlined in its Circular is required.

- Section 1012IA of Corporations Act and ASIC Policy Statement 184 (PS 184) should continue to apply subject to the relief given under Class Order 03/1097 indefinitely. In addition Section 1012IA should not apply to underlying investments in:
  - composite investment options where the trustee determines the asset allocation and selects the investment managers;
  - wholesale financial products or Pooled Superannuation Trusts in which a retail client cannot directly invest.

As terms of reference 5 and 6 are related IFF has chosen to respond to them as one.

5.1 SIS Requirements

The trustee of a superannuation fund is responsible for the prudential management of the investment of the fund's assets. This obligation applies under trust law and also under SIS.

(a) Investment Strategy

SIS requires the trustee to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the fund including, but not limited to:

- **Risk** - the risk involved in making, holding and realising investments, and the return on those investments;
- **Diversification** – the risk from inadequate diversification;
- **Liquidity** – the need to maintain sufficient liquid assets having regard to the fund's cash flow; and
- **Liabilities** – the ability to meet existing and prospective liabilities as they become payable.[37]

This over riding covenant, which forms part of the governing rules of all regulated superannuation funds and is also an operating standard, must be considered in the context of other provisions of SIS.

(b) Member Investment Choice

The investment strategy a trustee creates for a superannuation fund, will still comply with SIS if it permits beneficiaries to give directions to the trustee as to how they want their account balance invested, provided those directions:

- relate to the strategy to be followed by the trustee concerning the investment of a particular asset or assets of the fund; and
- are given in circumstances covered by the SIS Regulations.[38]

[37] Section 52(2)(f) SIS and regulation 4.09 of SIS Regulations

[38] Section 52(4) SIS

The circumstances covered by the SIS Regulations include a direction by a beneficiary as to which investment strategy or strategies he or she wants to invest in. This is subject to the trustee having provided the beneficiary with details of the investment objectives and all information necessary for the beneficiary to understand the effect of and any risk involved in those strategies.[39] This is also an exception to the prohibition against a trustee acting under direction.[40]

The difficulty for a trustee is how to strike a balance between these two obligations with one imposing on it a clear obligation to determine how fund assets are invested, and the other qualifying that absolute power by allowing a member to direct the trustee on specific investments.

5.2 APRA's Position

APRA's views are set out in APRA Superannuation Circular II.D.1 Managing Investments and Investment Choice (**the Circular**). The Circular states that there is no conflict between these two requirements:

> "*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.*"[41]

According to the Circular a trustee who is directed by a beneficiary as to how he or she wishes to invest is not relieved of its obligations under Sectio 52(2)(f) of SIS, particularly its duty to ensure liquidity and appropriate diversification of assets.[42]

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. The Circular requires the trustee to take a more intrusive role regarding a member's investment choice, which appears to be contrary to the policy initiatives leading to the introduction of Fund Choice. That is empowering members to have more control over their retirement savings.

5.3 Development of Member Investment Choice (MIC)

On the introduction of SIS in 1994 the vast majority of funds did not offer MIC. The common approach was a "one size fits all" investment strategy for all members of the fund, with members having no say in how their retirement savings should be invested. This was a very paternalistic approach and very different from the environment in which the industry operates today.

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[39] Regulation 4.02 SIS Regulations

[40] Section 58 of SIS

[41] Paragraph 7 APRA Superannuation Circular No. II.D.1 Managing Investments and Investment Choice

[42] Paragraph 8 APRA Circular No. II.D.1

(a) Fund Choice

When Fund Choice was first proposed the debate that followed included arguments that what was needed was MIC within a superannuation fund, rather than a choice between superannuation funds. In response to this debate there was a rapid growth in the number of funds outside of the retail sector, which introduced MIC to their members. Industry Funds were market leaders in offering MIC to their members.

(b) Increase in number and diversity of investment choices

Initially MIC offered members limited choices between 3 to 5 (on average) composite investment options developed by the Trustee. Over time these options have become more and more sophisticated, with many funds offering a wide range of investments for their members to choose from. This is not a new trend and has been developing over the last decade. It is a trend that was consistent with the Government's policy to allow people to have more control over investment of their superannuation savings.

(c) Legislation is out of step with industry

While the investment structure of SIS was appropriate for the industry as it existed in 1994, it is questionable whether it continues to be appropriate, particularly in view of the introduction of Fund Choice, which seeks to give the investor control over where retirement savings are invested.

The industry is constantly evolving in response to Government policies and market trends. The legislative framework that underpins the industry has failed to keep pace and the result is legislation and regulatory policy, which has not changed its position since 1994, trying to be relevant to a very different industry in 2006.

5.4 Recommendation on Trustee Obligations

The obligations of trustees concerning investments of a fund's assets are and should continue to be:

- deciding whether or not to make MIC available to members;
- determining the strategy and asset allocation for each investment choice offered;
- selecting and managing the performance of investment managers;
- selecting the default investment option,
- determining the strategies or products to be offered;
- determining the proportions in which members may invest across those strategies or products;
- managing those strategies or products (including appointment of investment managers and selection of managed investment products etc.);
- deciding how management costs will be recovered from the membership;

- ensuring appropriate disclosure and information is provided to members so that they can make an informed decision and that they are encouraged to seek financial advice; and
- ensuring fund solvency and liquidity.

This is what most trustees regard as being the extent of their obligations, which are substantial regardless of the number of the investment options they offer to members or the diversity of those options.
IFF submits that further discussion and review is required on APRA's approach as outlined in the Circular.

5.5 ASIC Policy Statement 184 – Superannuation: Delivery of Product Disclosure for Investment Strategies

ASIC PS 184 was issued on 3 August 2006 and relates to Section 1012IA of the Corporations Act which applies where a trustee offers MIC, and where any of the choices offered include specific financial products (**accessible financial products**) which the trustee acquires if instructed to do so by a member in order to invest in a particular investment strategy.

From 1 July 2007 (subject to relief given under Class Order 06/636) the trustee must give a member a PDS about any accessible financial product included in an investment strategy before the member acquires the product. The Trustee must also comply with the PDS requirements to prepare and provide the PDS for the Fund.

(a) What is an "accessible financial product"?

An accessible financial product is a particular financial product (e.g. a specific managed investment fund and not just the *type* of investment) that will be acquired by a trustee when a member selects a particular investment strategy offered by the fund.[43]

The rationale is that where a trustee acquires accessible financial products under a particular investment strategy it must give members the same information about those underlying investment products as the member would receive if he or she invested in those products directly. This is to ensure that a member can make an informed decision whether to instruct the trustee to invest in that particular investment strategy.

Examples of accessible financial products are:

- A term deposit with and identified Bank
- An interest in an identified managed fund.[44]

[43] Schedule 1 paragraph PS 184.88(a)

[44] Table 6 Schedule 1 PS 184

(b) What products are not "accessible financial products"?

Investment strategies under which the types of financial products that will be acquired to satisfy the strategy are specified (e.g. listed property trusts), but not the *particular* financial products that funds will be invested in, are not accessible financial products and Section 1012IA will not apply to them.

Examples given of investments where Section 1012IA will not apply are:

- An investment linked life product, within which a member may select an investment strategy involving particular financial products. Section 1012IA applies only to the life insurance policy.
- Particular securities for which a direct acquisition of the product would require a prospectus or other Part 6D disclosure document.
- One or more types of financial products (e.g. cash trust option, unlisted property trust option, fixed interest trust) but where the particular financial products to be acquired are not specified.
- One or more types of financial products and the PDS refers to particular financial products in order to illustrate the particular kinds of financial products comprising the whole or part of the strategy at a particular time, but there is no arrangement to acquire those particular products.[45]

The example given in PS 184 is as follows:

> *"For example, s1012IA will not apply to a statement that "as at 31 March, 40% of funds invested in Australian managed funds are in JKL Fund", if the trustee retains the right to invest in any managed funds at any time without seeking further instructions from the member."*

Therefore all a trustee need do to avoid Section 1012IA applying is to retain the right to invest in managed funds at any time without the need to seek the member's consent.

Where the investment strategy consists of both types of financial products and also specific financial products, Section 1012IA will apply to some but not to the others. This means if a member selects a balanced investment strategy with 4 types of financial products, one of which refers to 3 particular financial products, the member selecting the balanced option has to receive the fund PDS and in addition 3 separate accessible financial product PDSs prepared either by the trustee or the product issuer.[46]

(c) Effectiveness of Section 1012IA from a consumer protection perspective

To say the above is confusing not only for trustees but also for members would be an understatement. A major problem for all trustees is that members invariably do not read written material regardless of how it is presented to them. Section 1012IA simply adds to the amount of written material that must be given to

[45] Table 6 Schedule 1 PS 184

[46] Schedule 1 PS 184.90 Figure 1 Mixed strategy, Schedule 2 PS 184.102 Figure 4

members and which is unlikely to be read by them and therefore from a consumer protection perspective Section 1012IA will be largely ineffective.

While the Government is urging the industry to reduce the size of a PDS this initiative will result in significant increases in the material that must be given to members, with no tangible improvement in consumer protection.

Providing members with multiple PDSs will only confuse them and in some cases mislead them. It will not promote a better understanding of their investment choice, which is apparently the intention.

IFF submits that Section 1012IA should only apply in limited circumstances where members are effectively provided with an investor directed portfolio service through a superannuation fund. That is, where members can create their own investment portfolio. Even in this case the relief given under class order 03/109,7, which allows an exemption to comply with Section 1012IA until 30 June 2007, should continue to apply as it provides adequate disclosure.

Section 1012IA should not apply in the following circumstances:

(i) Composite Investment Options

It is apparent from PS 184 that even composite investment options where the trustee determines the asset allocation can be caught. Examples given refer to a balanced option where some assets will require provision of an accessible financial product PDS and others will not.[47]

These investment options are very different from direct investment in shares or securities and generally are selected by members due to their simplicity, and according to their individual risk tolerance or years to retirement. The additional information required under Section 1012IA in these circumstances will add no value and just add complexity, create confusion and increase costs.

(ii) Wholesale Products and Pooled Superannuation Trusts

Section 1012A relates to products sold to retail clients. Many of the investments in which a trustee invests are wholesale products or Pooled Superannuation Trusts (**PST**). Most members cannot invest directly in wholesale products and if they do they do not invest as retail clients.

Similarly only trustees of superannuation funds can invest in a PST, and therefore members can never directly invest in this type of financial product. Access to these products is one of the advantages of investment through a superannuation fund as it allows retail investors access to investments, which would otherwise be unavailable to them.

[47] See examples on page 32, 33, 34, 35 and 36 of PS 184

Section 1012IA requires provision of a PDS for an underlying product if a PDS would be required for that underlying product *if the client acquired it directly* under section 1012B(3) or 1012C(3). For this purpose an equivalent direct acquisition is an acquisition that would occur if the product were offered direct to the client and the circumstances of issue were otherwise the same. Sections 1012B(3) and 1012C(3) relate only to retail clients and have no application to wholesale products and members cannot invest directly in a PST.

IFF submits that where the underlying investment in a particular investment strategy is:

- an investment in a wholesale product which is not available to retail clients; or
- a PST, which by its nature can only accept investment from the trustee of a superannuation fund and not directly from a retail client,

Section 1012IA should not apply because the member is unable to invest directly in these underlying investments and can only access them via a superannuation fund.

The underlying principles for this policy are stated as ensuring members of superannuation funds receive the same disclosure concerning accessible financial products as they would be given if they were investing directly in those products as retail clients. As in the case of wholesale investments and PSTs this is clearly not possible, excluding these products would not be inconsistent with the underlying [48]principles stated in PS 184.

5.6 Options for Complying with Section 1012IA

There are 2 options for providing information about accessible financial products to members to satisfy the requirements of Section 1012IA under relief provided by modifications to the disclosure obligations in Part 7.9 of the Corporations Act.

(a) Option 1: Trustee prepares a PDS for the accessible financial product

Under this option the law has been modified to allow a trustee (rather than the actual product issuer) to prepare the PDS for the accessible product and give it to its members. The accessible product PDS does not form part of a multi-part PDS under Section 1013L of the Corporations Act, and is not a supplementary PDS under Section 1014A of the Corporations Act. It is a “stand-alone” document.

The intention is to allow trustees to “tailor” the content of this accessible product PDS to address the specific information need by the fund’s members. This is achieved by reliance on Section 1013F of the Corporations Act that allows a trustee to decide what information to include in a PDS taking into account that the product is accessed through a superannuation fund with its own PDS.

[48] PS 184.27

This option would impose on a trustee:

- A burden to produce a PDS in addition to the PDS for its own product (i.e. the superannuation product), for which it is not the product issuer and over which it has no direct control.
- Increased compliance costs and operational costs to produce such a document.
- Increased exposure to liability for disclosure in endeavouring to "tailor" the PDS in reliance on Section 1013F
- An obligation to ensure the PDS is up to date while having no control over the product it relates to.

It is unlikely that trustees will be prepared to assume this additional risk and expense which would ultimately be passed on to members.

(b) Option 2: Trustee gives member the PDS for the accessible product prepared by the product issuer of that product

Under this option the trustee prepares the PDS for the fund and also provides the member with the PDS of the accessible financial product prepared by the product issuer.

This option will allow the trustee to rely on the PDS of the product issuer. However, where the product is a wholesale product or a PST in which retail clients cannot invest, the PDS will not be drafted for sale to retail clients via a superannuation fund. It is unlikely that the product issuer will be prepared to bear the expense of drafting a separate PDS to fit this situation.

(c) How often you must give an accessible product PDS

Product disclosure obligations under Section 1012IA are ongoing. Without modification this would mean a trustee would have to give the member an accessible financial product PDS every time an acquisition of that product occurred, even where a standing instruction from the member is held.[49]

Where additional acquisitions[50] are made for a member the trustee is required to give the member a PDS for each additional acquisition. This would include whenever the member invests further contributions or transfers/rollovers of benefits in the same investment option he or she has previously invested in.

Class order relief[51] allows the trustee to rely on information previously given (e.g. in the PDS provided when the product was purchased). However, this relief is subject to an obligation on the trustee to keep the PDS information up to date and meeting the following requirements which apparently are intended to avoid an over supply of information to members:

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[49] PS 184.69

[50] An additional acquisition is defined in relation to a member as a regulated acquisition of an accessible financial product at a time when the trustee is already holding a financial product of the same kind as a result of an instruction given by the member. (PS 184.113, Section 1012IA Corporations Act.

[51] Class Order [CO 06/636]

- **Members joining on or after 1 July 2007 - New members**

  The trustee must give a new member joining for the first time a written warning, that they may not have the most up-to-date information when the trustee makes the additional acquisition of the product, or have been given disclosure about material changes and significant events that affect the accessible financial product. The member must give the trustee a written acknowledgement that they have understood this warning.[52] Obviously this can be included in the application form of the member on joining.

- **Members who joined on or before 30 June 2007 - Existing members**

  Written notice with the same information to be given to new members must be given to existing members. How this disclosure is given is left to the trustee. The examples given are in a periodic report, annual fund statement or in a separate mail out.[53]

  PS 184 indicates that there is no need to obtain a written acknowledgement from existing members. However, as relief is subject to this statement being given the trustee will need to be confident of the method used for delivering it.

  Obviously such a notice would have to be sent before 30 June 2007 so that members have received it before the trustee invests further amounts on behalf of existing members post 30 June. Consequently it may not be possible to combine this notice with a mail out of a compliance document. If this is the case the fund will incur the cost of a one off mail out. It is likely that the only purpose this will serve is to confuse existing members.

(d) Initial investment choice and switch requests

A member must be given a copy of the relevant accessible product PDS before the trustee can act on an instruction from the member to invest in that particular investment option. The PDS can be given at the request of the member, or if no request is made the trustee must give the member the relevant PDS before implementing the member's selected strategy.

(i) Initial investment choice

The intention appears to be that the member will notify the trustee which investment option he or she wishes to select and on receipt of this information the trustee will send the accessible financial product PDS to the member before acting on the member's instruction. This turns the process of a member joining the fund into a two-step process and delays investment in the investment options selected by the member.

[52] PS 184.72

[53] PS 184.73 and 184.74.

(ii) Switching between investment options

Similarly whenever a member switches to a new investment option, that switch cannot be processed until the trustee "gives" the member a copy of the relevant accessible financial product PDS.

This changes a three-step process (receipt of the switch, exercise switch and confirmation it has been done) into a five-step process (receipt, forward PDS, obtain member acknowledgement, exercise switch and confirm switch).

This will greatly delay a switch from being executed, which will be contrary to member expectations. Timing of a switch is often critical and delays in executing it can disadvantage the member (e.g. where a market correction occurs).

Although not stated just posting it out or whatever other means of "giving" it is adopted, will not be sufficient. If the purpose of giving it prior to the investment is to ensure the member has made an informed decision, then the trustee would have to be sure that the member received it, read it and understood it, and still wanted to proceed with the switch. Consequently confirmation from the member to proceed would be an essential part of this exercise.

(e) Default Option

PS 184 states that as the default strategy applies by default and not as a consequence of a direction by a member there is no "instruction" given by a member. Therefore Section 1012IA does not apply to the default strategy. As the vast majority of members remain in the default strategy this provides some relief from these requirements. However, because it is not necessary for a member to take any action in order to invest in the default option, it is not possible to determine which members are in the default due to apathy and which members have made a conscious choice to remain in the default.

As typically 90% of members of Industry Funds are invested in default options, the vast majority of members derive no benefit at all from these requirements, but all will bear the increased cost in compliance.

(f) Providing replacement PDS if original becomes "defective"

If the PDS for the accessible financial product becomes defective[54] the trustee must give the member updated information and an opportunity to select a different investment strategy as soon as practicable after the trustee becomes aware of the defect. The following note appears at the end of PS 184.75:

> *"The opportunity for the member to select a different investment strategy must be available despite any limit in the superannuation entity's rules on the number of times that a member may change their selected investment strategy in a specified period."*

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[54] "defective" as defined in Section 1021B(1) Corporations Act

This would mean that the terms of the trust deed could be over ridden. This should only apply in circumstances where the defect is materially detrimental to the member.

5.7 How the SIS Act Applies

PS 184 states that trustees must also comply with the disclosure aspects of the SIS requirements and apply the requirements of Section 1012A in that context. This includes the obligation to formulate the investment strategy according to Section 52(2)(f) and to accept member directions under Section 52(4).

PS 184 provides that a member direction under Section 52(4) made in accordance with SIS Regulation 4.02 will not breach Section 52(2)(f) if the instruction relates to the strategy in which particular assets are to be invested.

Under regulation 4.02 a trustee must provide the following information:

(a) the investment objectives of each investment strategy;

(b) all information the trustee reasonably believes a member would reasonably need to understand the effect of each of those strategies and any risks involved in them; and

(c) details of the range of instructions that can be given and the circumstances in which they can be changed.

These obligations remain concerning the fund PDS, which must also comply with the Corporations Act obligations including Section 1012IA unless one of the two options referred to above is adopted by the Trustee. IFF submits that the obligations in SIS and the disclosure obligations in the Corporations Act are sufficient to ensure members have all the information they need to select the investment strategy in which they want to invest, without the additional requirements of Section 1012IA.

5.8 Recommendation on Section 1012IA and PS 184

As neither of the two options proposed are likely to be acceptable to trustees, compliance with Section 1012IA will inevitably lead to a substantial increase in the size of a fund's PDS and a corresponding increase in the cost of producing it, without any real benefit to members.

IFF submits that the relief given under class order 03/1097 which allows an exemption to comply with Section 1012IA until 30 June 2007, should be permanently substituted for the requirements under section 1012IA. That relief applies if the fund's PDS includes or is accompanied by written information as to how a member can obtain a copy of a PDS for the accessible financial product or if available electronically, prominently draws attention to information about how a copy of the PDS for the product may be accessed (e.g. by hypertext link).

IFF also submits that instead of imposing additional requirements that increase the cost and burden of written disclosure that more resources be committed to the education of consumers to increase awareness and financial literacy.

5.9 Own Product Bias

Some providers offer a reasonably high percentage of their own products under investment choice arrangements. This can lead to an inappropriate spread of assets at fund and individual member level.

[Comment: need to state how we want the government to respond to this statement. For example do we propose legislative change to limit this type of activity and if so in what circumstances?]

5.10 Cost of Establish MIC

It is important to manage the cost of offering a high number of investment choices to ensure that the costs are recovered on a fair and reasonable basis. [***SIS requires costs to be allocated on a fair and equitable basis. What do we want to recommend here? Do we want to amend SIS to something more prescriptive?]***

5.11 Access to Financial Advice

For members to make informed appropriate choices concerning their retirement strategy and investment choice, they need access to limited advice provided by an approved provider who is not remunerated by commissions. See detailed discussion on this issue in our response to term of reference number 4.

6. THE REASONS FOR THE GROWTH IN SELF MANAGED SUPERANNUATION FUNDS (TERM OF REFERENCE NO. 7)

Our understanding of this term of reference:
Consideration of the reasons behind the unprecedented growth in this part of the industry, and the risks and consequences of that growth for the superannuation industry and the community.

Our position:

- Trustees of these funds should be required to have an appropriate level of understanding of their obligations as trustees in the same way as other trustees. Appropriate training and fit and proper requirements should be imposed.
- Legislation and regulation of this sector should be strengthened to ensure that SMSFs are used for the accumulation of retirement savings and not to pursue other business interests.
- Collection and publication of data on the performance of this sector of the industry should be available to consumers considering establishing an SMSF.

On 5 September 2006 The Treasurer announced final decisions concerning the simplified superannuation proposals contained in the Budget. Those decision included improvement in the regulation of self-managed superannuation funds (**SMSFs**) by increasing funding to the Australian Taxation Office (**ATO**) for compliance activities, streamlining reporting requirements and other measures. It also includes increasing the supervisory levy for these funds to $150 to place them on a similar cost recovery basis as other superannuation funds.

These announcements are a welcome indication of the Government's commitment to improving the supervision of SMSFs and ensuring that they bear a realistic share of the costs involved in that supervision through the supervisory levy. The ATO has had limited interest in the operational and prudential issues associated with SMSFs. It is hoped that this increase in funding will be used to provide a more proactive approach to supervision of SMSFs.

Given the unprecedented growth in this area, the lack of prudential supervision is of concern. Trustees of these funds are not subject to the fit and proper requirements and other obligations imposed on trustees of APRA supervised superannuation funds. These funds still represent superannuation savings concessionally taxed, and from 1 July 2007 even more so. The fact that so much of Australia's retirement savings are tied up in these funds should be of concern to the Government.

Government policies actively encourage growth in this area (e.g. low levies, lesser regulation etc.). There is an ongoing risk that some promoters of SMSFs may mislead consumers. Consumers are not always well advised on the costs and the benefits of establishing an SMSF compared to placing their retirement savings in an Industry Fund or other public offer fund. The hard work and responsibility, as well as the knowledge required to manage an SMSF may not be appreciated or understood.

It is apparent that some financial advisers and accountants are directing people who have insufficient retirement savings to make an SMSF a cost effective option, into SMSFs. Often this is as a result of commissions payable to the financial adviser and in the case of accountants' fees from the ongoing management of the SMSF.

It is also apparent that this sector of the industry is more likely to use an SMSF to pursue other business objectives that are not consistent with SIS or Government Policy. This is as a consequence of less stringent regulation and supervision applicable to SMSFs.

Unlike the rest of the superannuation industry there is little or no data available to a consumer on the performance or cost of an SMSF. Consequently a consumer has no way of comparing the performance or cost of an SMSF with that of other alternative superannuation funds. As consumers may have an unrealistic expectation of setting up an SMSF, the ATO should collect appropriate data from trustees of SMSFs, which should be made available to APRA to publish and report on as part of other superannuation data made available to the public by APRA.

IFF submits:

- Legislative changes should be made to prevent inappropriate advice to set up an SMSF by imposing:
  - a minimum account balance for establishing an SMSF;
  - a 12 month transition period for existing SMSFs that cannot meet that requirement to transfer to a regulated superannuation fund; and
  - an exemption on capital gains tax (and if at all possible stamp duty) to facilitate SMSFs below the minimum account balance transferring to other superannuation funds.
- That Trustees of these funds should be required to have an appropriate level of understanding of their obligations as trustees in the same way as other trustees. Appropriate training and fit and proper requirements should be imposed.

- That legislation and regulatory supervision of this sector of the industry should be strengthened to ensure that an SMSF cannot be used to pursue other business activities not consistent with SIS.
- That the ATO be given the power to collect data on SMSFs to be published by APRA so consumers are able to make informed comparisons with other superannuation funds.

7. THE DEMISE OF DEFINED BENEFIT FUNDS AND THE USE OF ACCUMULATION FUNDS AS THE INDUSTRY STANDARD FUND (TERM OF REFERENCE NO. 8)

It is important to ensure that defined benefit funds are adequately regulated and managed even though they continue to decline rapidly in number and coverage. It is important to protect the benefits of members of these funds in the same way as accumulation fund members.

It is also important to ensure that these funds are appropriately funded to avoid a shortfall in the event of an employer sponsor becoming insolvent.

8. COST OF COMPLIANCE (TERM OF REFERENCE NO. 9)

Our understanding of this term of reference:
A consideration of the cost resulting from the substantial changes to compliance obligations of superannuation funds through legislative changes, the impact of those costs on the industry compared to the increased protection the changes provide.

Our position:
- Dual regulation and licensing of superannuation funds should be removed in favour of a single regulator.
- Trustees should only be required to notify one regulator of a material breach under the breach reporting obligations for APRA and ASIC.
- The level of detailed information required in a PDS and under S 1013E of the Corporations Act, and the lack of clarity about its limits reduces its effectiveness and increases the cost in producing it
- The operation of Section 1012IA of the Corporations Act referred to in our submission on terms of reference 5 and 6 above adds complexity without adding value for the consumer.
- Lack of financial literacy and access to financial advice should be the focus of Government initiatives in this area.

While IFF supports a robust compliance regime, it is conscious that such a regime will, by necessity, involve significant costs, which will ultimately be borne by members of superannuation funds, at the expense of their retirement savings.

It is therefore essential to strike an appropriate balance between the need for effective prudential supervision, and the need to ensure that superannuation funds operate cost effectively to maximise the amount available to members in retirement. If this balance is not achieved the cost of supervision will operate to the disadvantage of the very people it seeks to protect, being the members of the funds.

8.1 Dual Regulation and Licensing

IFF submits the current dual regulation of the superannuation industry by APRA and ASIC leads to duplication of compliance and unnecessary complexity, which results in higher costs of compliance.

This is reflected in:

- the need for APRA and ASIC to have in place a memorandum of understanding to try and deal with the overlap in their regulatory responsibilities;
- the need for public offer superannuation trustees to hold both an Australian Financial Services Licence from ASIC, and a Responsible Entities Licence from APRA with different requirements and obligations, often dealing with the same areas; and
- The duplication of obligations imposed on trustees of superannuation funds in the SIS Act and the Corporations Act (e.g. Disclosure obligations, complaints, governance, breach reporting).

IFF submits that the dual regulator model is inefficient and costly. A single regulator should have sole responsibility for all aspects of superannuation. In addition there should be one licensing regime under which superannuation trustees operate.

8.2 Breach Reporting

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.

Trustees should only be required to notify one regulator of a material breach. The Regulator can either deal with that breach or refer it to the other Regulator where appropriate.

8.3 Disclosure

Some compliance requirements do not add value for members and should be reviewed as they result in unnecessary costs and added confusion for members. These include:

The level of detailed information required in a PDS and under S 1013E, and the lack of clarity about its limits reduces its effectiveness and increases the cost in producing it. Issuers are required to include any other information that might reasonably be expected to have a material influence on the decision of a reasonable consumer on whether or not to buy the product. In addition the operation of Section 1012IA of the Corporations Act referred to above adds further complexity.

The penalties for breach can be significant. Consequently 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.

IFF submits the short form PDS option has failed to resolve these issues. The fact that only one short form PDS has been issued speaks for itself.

The reluctance of consumers to read the disclosure material, the lack of financial literacy and lack of access to independent financial advice are the areas which should be the focus of the Government's initiatives in this area. The addition of more onerous disclosure obligations on trustees does nothing to protect the consumer.

9. THE APPROPRIATENESS OF THE FUNDING ARRANGEMENTS FOR PRUDENTIAL REGULATION (TERM OF REFERENCE NUMBER 10)

Our understanding of this term of reference:
A consideration of how the cost of regulation is funded including the supervision levy and whether that approach is appropriate and equitable.

Our position:

- Cross subsidies should be removed from the calculation of the Supervision Levy.
- The Supervision Levy should be determined according to risk and not the size of the fund.
- Adequate professional indemnity and fidelity insurance should be mandatory for all trustees

9.1 Cross Subsidisation

The cost of regulation funded from the superannuation industry by way of the Supervision Levy needs to be reviewed to eliminate the cross subsidies within the superannuation sector.

Currently the larger superannuation funds are subsidising the cost of supervision of the smaller funds. This is inequitable and fails to differentiate between high risk funds and low risk funds.

9.2 Assessment According to Risk

IFF submits that the Supervision Levy should be based on risk not size. It is unacceptable to expect well run funds to subsidise those that are non-complying or fail to operate efficiently and this should be reflected in how the Supervision Levy is applied.

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

IFF submits that APRA should apply its Probability and Impact Rating System to determine a risk rating for a fund and on that basis the amount of Supervision Levy it should pay.

9.3 Insurance

IFF submits that Trustees be subject to a mandatory requirement that all funds maintain both professional indemnity insurance and fidelity insurance, supported by strong regulation of particular funds or types of funds identified as being at risk.

Although the risk management requirements imposed on RSE Licensees under SIS refer to insurance as a way of transferring risk[55] there is no legislative requirement for trustees to maintain appropriate insurance cover. Making this type of cover mandatory offers further protection against operational risks and fraud.

10. WHETHER PROMOTIONAL ADVERTISING SHOULD BE A COST TO A FUND AND, THEREFORE, TO ITS MEMBERS (TERM OF REFERENCE NO. 11)

Our understanding of this term of reference:
Whether it is appropriate for a trustee to recover the cost of advertising from member accounts.

Our position:

- The cost of advertising is a legitimate expense of a superannuation fund like any other administration or operational expense and there is no justification for treating it differently.
- The primary objectives of Industry Fund expenditure on advertising are retention of members and funds under management (**FUM**), and growth in membership and FUM.
- Retention of member numbers and FUM is essential to maintain economies of scale, which in turn provides access to competitive management and administration fees, which is in the best interests of members.
- Members pay all advertising costs directly or indirectly regardless of a fund's business model.
- Fund choice is based on an informed market and a level playing field for all participants in that market. Requiring "all profits to members" funds to fund the cost of advertising from resources external to fund assets effectively operates as a ban on those funds advertising, as they do not hold other financial resources.

[55] Paragraph 32, Superannuation guidance note SGN 120.1 Risk Management

- An inevitable consequence of such a ban would be a significant reduction of competition in the industry.

This issue has been investigated previously and raises significant issues for Industry Funds, which do not promote their products via a financial planning distribution network either directly or indirectly by payment of commissions.

For these funds the purpose of advertising is two fold:

- **retention of existing members** - making current members aware of new products or improvements to existing products is an important part of a fund's member retention strategy and how it protects its economies of scale; and
- **attracting new members -** bringing its products to the attention of prospective members to allow it to grow its economies of scale.

In addition as "all profits to members" funds hold no assets in their own right (i.e. they only hold assets as trustee for members of the fund), they have no other financial resources from which to fund advertising.

10.1 Is the cost of advertising an expense of the fund?

It is not clear why the cost of advertising should be treated differently from any other management, administrative or operational expenses of a superannuation fund, which can be paid from members' accounts.

A primary objective of advertising is to retain members and FUM and consequently the fund's economies of scale. Loss of economies of scale can directly lead to an increase in management and administration fees, which are usually linked to the level of FUM and member numbers respectively. It is therefore in the best interests of members of the fund to protect the economies of scale to ensure fees and other benefits remain competitive.

The ability to communicate effectively with current and prospective members is also essential. In the case of current members a number of activities could be classed as "promotional advertising" or promotion, but are in fact legal obligations of disclosure imposed on trustees. For example the obligation to:

- inform members of material changes and significant events[56];
- provide a periodic statement that provides information the product holder needs to understand his or her investment[57];
- to provide specific information concerning management, financial condition, investment performance, benefit entitlements, how to make inquiries and or complaints[58].

[56] Section 1017B Corporations Act

[57] Section 1017D Corporations Act

[58] Section 1017DA Corporations Act

Even the content of a product disclosure statement can include promotional material as well as prescribed information. Policy Statement 168 refers to the inclusion of extraneous information in a PDS (which includes advertising or promotional material) by the product issuer or even by a third party.[59] This is subject to the trustee ensuring that the extraneous material in a PDS is clearly distinguishable from other information and is not more prominent than other information.

This is clear recognition that advertising is an integral part of the operations of a superannuation fund. Such expenditure should be funded in the same way as any other cost of doing business.

10.2 What is "promotional advertising"?

It is not apparent what this term of reference is addressing as the term "promotional advertising" can apply to publicity, promotion and direct and indirect marketing. As indicated above it could also include compliance documents, and notification to existing members of improvements to existing products, which in some cases is required by law (e.g. significant event notification under Corporations Act), or a national television advertising campaign. It could also apply to educational materials and activities such as retirement seminars.

Any attempt to restrict how "promotional advertising" is to be funded will require a careful consideration of what that terms means. Having to differentiate between which material can be funded and from what source will present trustees with further difficulties. When the promotional material is incorporated in a compliance document determining what part of the cost of producing that document applied to the promotional material would be difficult if not impossible.

10.3 Educational material

Responsible advertising can be an important part of educating members on superannuation. It can motivate people to become more interested and involved in planning and saving for their retirement. It can also inform them about issues they need to be aware of and expose pitfalls they need to consider in making choices. If Industry Funds could not fund this activity it would deny members a valuable service.

10.4 Who really bears the cost of "promotional advertising" in "for-profit" funds?

The concept that "for-profit" funds do not fund promotional advertising from fund assets is misconceived. The reality is that although "for-profit" funds are able to fund promotional advertising through other parts of a corporate group, the cost is ultimately funded from members' money indirectly through higher fees. This is essential for these funds to deliver the levels of return to their shareholders.

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[59] Paragraphs 168.55 to 168.57 of PS 168

Recent research by AC Nielsen[60] indicates that the 5 largest Banks spent an aggregate of $45.5 million on print, electronic, outdoor, direct mail and online media on advertising for traditional, superannuation and insurance products during the June 2006 quarter. This is thought to be more than twice what was spent by the entire industry superannuation fund sector for the whole year.[61]

Introducing such a limitation would therefore directly discriminate against the "all profits to members" funds, provide the "for-profit" funds with a clear advantage, while failing to deliver any advantage to the consumer.

10.5 Consequences for "all profits for members" funds

The "all profits for members" funds would be placed at a significant disadvantage by this proposal, which would clearly favour their competitors in the retail sector of the industry. It has the potential to re-align the superannuation industry by facilitating the demise of industry funds, in favour of retail funds. The consequences of this would be that members are worse off and the Government's policy to encourage people to save for their retirement will be thwarted.

IFF submits that such an outcome would not be in the interests of the consumer and would be counter to the Federal Government's own policy to promote competition in the industry in order to reduce costs.

Part IV of the Trade Practices Act (**TPA**) covers anti-competitive practices that limit or stop competition. This Part prohibits commercial conduct that substantially lessens competition in a market, as a lack of competition might allow some traders to push prices up and lower the quality of the goods and services they offer to consumers.

Under the TPA a substantial lessening of competition is apparent when the ability of buyers to shop around for a deal that suits them is significantly diminished. IFF submits that this would be the effect of denying the "not for profit" superannuation funds access to funds for advertising. The industry should offer a level playing field to all players to the extent that is possible given the diversity of the industry.

There needs to be a level playing field for all superannuation funds with respect to this issue as it is central to accessing and increasing economies of scale.

10.6 Current position

IFF supports the intent of the Sole Purpose Test to maximise the retirement benefits of members. This test should and is applied by APRA to Industry Funds and unless the fund can show that advertising is in the best interests of members to protect or grow the fund's economies of scale APRA has said it will step in.

Protecting and increasing a fund's economies of scale is in the best interests of members as it allows the trustee to obtain competitive administration and investment management fees and also access to improved Group Life Insurance.

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[60] AC Nielsen is the world's leading marketing information company operating in more than 100 countries providing measurement and analysis of consumer attitudes and behaviour.

[61] Article by Alex Dunnin, 1 September 2006, Rainmaker Financial Standard Newsletter.

If the claims experience of two funds is the same, it will always be the larger fund that pays the biggest premium that will be able to negotiate better premium rates for its members as there is less chance of members selecting against the insurer. The insurer will want to maximise its market share, and the bigger the number of members the lower the dollar value of fixed costs per member will be, which results in lower premiums.

In addition Industry Funds provide members who may not otherwise be able to purchase insurance, with access to insurance cover at a reasonable cost. This is possible because Industry Funds offer automatic acceptance where all members who are fit to work can access insurance on joining a fund, and not just those members who are healthy. This provides a substantial benefit not only for the member, but also for his or her family. It also benefits the community as a whole as the Government does not have to provide for the family of members on death who have adequate insurance, or for a member who becomes disabled and has access to an insurance benefit.

In its submission to the Inquiry the Australian Retailers Association has stated that as a consequence of Fund Choice superannuation funds have no choice but to advertise because it is an essential part of attracting and retaining members and can educate current and prospective members about the benefits of the fund and its services. IFF agrees with this statement.

Consequently advertising to promote a brand, its offerings and distinguishing features can benefit all members if it results in maintaining or increasing economies of scale. It can also benefit the community by ensuring those in need have access to adequate insurance cover, thus reducing or removing the burden on taxpayers.

IFF submits that there is no justification for any change in this area, but clarification of APRA's views on this issue would be welcomed by the industry.

11. THE MEANING OF THE CONCEPTS "NOT-FOR-PROFIT" AND "ALL PROFITS GO TO MEMBERS" (TERM OF REFERENCE NO. 12)

Our understanding of this term of reference:
Whether the meaning of these terms is generally understood and whether they are appropriate to describe those parts of the superannuation industry that do not operate on a "for-profit" basis.

Our position:
These terms are commonly understood and relate to the intent of the trustee (i.e. what is the purpose for which the superannuation fund was established and continues to exist).

The term "all profits go to members" has been widely discussed and accepted by the Regulators and strongly endorsed at public forums. It applies to Industry Funds and is adopted in preference to the term "not-for-profit" which can be misinterpreted by members.

While clearly there are organisations that derive a profit from providing services to Industry Funds (e.g. fund managers, administrators, accountants) it is the purpose for which the trustee entity exists which is relevant to whether it operates on an "all profits go to members" basis.

11.1 Test is based on intent

The term "all profits go to members" is understood to apply to the promoting entity. Where the business objective of the promoting entity is to make a profit for its shareholders it clearly cannot be described as "not-for-profit", and to do so would be misleading.

It is important to understand that what differentiates a "not-for-profit" or "all profits go to members" organisation from a commercial one is not the actual profit outcome but the intent. The test therefore should be:

> *What is the ultimate purpose for which the superannuation fund was established and the basis on which it continues to operate?*

11.2 "not-for-profit" or "all profits go to members" does not mean "no profit"

These terms are not new terms. They have been widely used to describe charities and benevolent organisations, and are well understood by the community. This includes recognising that many "not-for-profit" charities trade goods and run businesses to make a profit, which is in turn directed back into the organisation to assist in achieving its charitable purpose.

In the context of a superannuation fund, for a corporate trustee to be "non-profit" would mean that any profit it makes is not paid to shareholders but is retained for the purposes of the superannuation fund. This is no different to some charitable organisations or hospitals, which operate on a commercial basis.

From a member's point of view, there is no evidence to say there is a better model than the "all profits go to members" model. This is evidenced by the 'Compare the Pair' advertising campaign, which highlights the significant difference in end benefits to the member between funds invested in an "all profits go to members" fund and those invested in a fund set up to make profits for the shareholders of the entity that owns the fund.

The difference in the results is due to the impact of payment of commissions and the need to provide shareholders with profits through capital growth and/or dividends.

12. BENCHMARKING AUSTRALIA AGAINST INTERNATIONAL PRACTICE AND EXPERIENCE (TERM OF REFERENCE NO. 13)

The three-pillar Australian retirement income system is recognised internationally as World-Class. The superannuation industry, which is seen as central to this, is therefore included in many international comparisons and benchmarking exercises[62]. As one of the few countries with compulsory superannuation Australia is a World leader and other countries regularly consider the Australian system when developing their own.

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[62] Policies for an Ageing Society: Recent Measures and areas for further Reform, Economics Department Working Papers No. 369, 20 November 2003 OECD
Pension Supervision: Understanding International Practice and Country context, May 2005 Social Protection Unit, Human Development Network, The World Bank

13. LEVEL OF COMPENSATION IN THE EVENT OF THEFT, FRAUD AND EMPLOYER INSOLVENCY (TERM OF REFERENCE NO. 14)

Our understanding of this term of reference:
How members will be compensated for loss due to these events and what safeguards should be in place to protect then from suffering that loss.

Our position:

- IFF believes that all members of regulated superannuation funds must be protected against loss of their retirement income as a result of theft, fraud and employer insolvency.
- Mandatory professional indemnity and fidelity insurance by trustees should be legislated.
- Superannuation levies should be based on account balance rather than fund size to avoid an unfair burden falling on members with low account balances.
- SG contributions should be paid monthly to reduce risk and trustees should be given legislative support to actively pursue arrears of contributions.

It is important to put this issue in perspective. Evidence suggests that the incidence of loss stemming from illegal behaviour involving Australian superannuation funds is low, representing approximately 1% over a 13 year period.[63]

The very low failure rate suggests SIS and the Corporations Act are providing an appropriate regulatory framework, which, in part, is acting as an effective deterrent against illegal behaviour and is providing valuable guidance toward effective fund governance.

13.1 Compensation Under Part 23 of SIS

IFF submits that:

- fidelity insurance cover for trustee entities should be mandatory to reduce the instances in which Part 23 would need to be applied; and
- compensation under Part 23 should be a tool of 'last resort', to be applied only where considerable injustice would result from the consequences of criminal behaviour (fraud or theft), and where fidelity insurance was not effected.

13.2 Funding of Compensation by Levies

IFF submits that funding compensation through a levy raised on the superannuation industry is inappropriate and regressive in its nature. This is because the impact of a flat levy (as a proportion of assets) will have the greatest impact on those members who have small account balances and are least able to afford it.

If the status quo is retained, IFF recommends differential levies based on account balance, taking into account the relative size of the account balances.

[63] An article quoting APRA figures put the estimated quantum of loss at $70 million since 1988[63].

13.3 Cost of Regulatory Reform Compared to Benefits

IFF submits that as a condition precedent to any reform recommendations the Committee makes, that it carefully and transparently models the compliance costs involved. Such costs should be considered in terms of their impact on the final retirement balances of members, competition between superannuation funds and the desirability of promoting Australia as a cost effective global financial centre.

13.4 Security of Additional Voluntary Contributions Paid by Salary Sacrifice

Currently contributions paid by an employee under a salary sacrifice arrangement with an employer are not subject to the time limit imposed on employers for payment of all other superannuation contributions, including voluntary member contributions and SG contributions. Section 64 of SIS is confined to contributions “deducted from salary”, which would not include salary sacrifice contributions that do not form part of a member’s “salary”.

IFF submits that these contributions be subject to a requirement that they be paid within 28 days from the end of the month in which these contributions were deducted from the employee’s salary.

13.5 Pay all Contributions Monthly

IFF submits that the most effective way to protect members from employer insolvency is prevention. That is, that all contributions (employer, salary sacrifice and employee after tax contributions) be payable monthly to the member’s chosen fund or default fund as the case may be.

13.6 Recovery of Arrears of Contributions

In addition to requiring payment of SG contributions monthly, IFF submits that the duty of a superannuation fund trustee to act in the best interests of members at all times, includes having in place an active and comprehensive contributions arrears recovery system. Effective and timely action to recover arrears can avoid a situation escalating and minimise any loss to members in the event of an Employer becoming insolvent.

A major impediment to trustees recovering arrears of contributions from an employer on behalf of members is the absence of any legal right to do so. Currently the only basis for a trustee to legally pursue arrears of contributions is where there is a written agreement between the trustee and the employer sponsor requiring payment of contributions and specifying when such contributions should be paid.

As a result of the Fund Choice legislation there has been a decline in these written arrangements between the employer sponsor and the trustee. If a trustee requires an employer to sign an agreement before accepting SG contributions, the employer is entitled to reject the fund as a chosen fund of an employee.

Currently the only requirement is for a trustee to advise members in its periodic statement of any amount of overdue contributions the trustee is, or should be, aware of and any action the trustee has taken or proposes to take to have the contributions paid[64]. In most cases a trustee will not be aware of overdue contributions as there will be no agreement between the trustee and the employer concerning the amount to be contributed or the frequency of contributions. Even if the trustee is aware of overdue contributions, in the absence of a contractual obligation enforceable by the trustee against the employer, there will be no legal right available to a trustee to pursue the arrears.

IFF submits that to overcome these issues:

- an obligation be imposed on trustees under SIS or the Corporations Act concerning recovery of arrears of contributions;
- trustees be given a legal right to pursue recovery of any arrears in combination with a requirement that employers must contribute SG contributions monthly so that trustees will always be aware when contributions are overdue.

13.7 Insurance to Mitigate Loss

IFF supports a mandatory requirement that all Trustees maintain Professional Indemnity Insurance, as well as Fidelity Insurance to replace the current levy system or alternatively to support it. Such a requirement could provide an effective resource in the event of a major loss as a consequence of fraud or negligence.

14. ANY OTHER RELEVANT MATTERS (TERM OF REFERENCE NO. 15)

Matters referred to are as follows:

- The present SG threshold of $450 should be removed.
- Trustees should proactively facilitate consolidation of members' accounts, a centralised ERF managed by the Government should be established to receive all lost member accounts.
- Fund mergers should not trigger a CGT liability.

14.1 Removal of Superannuation Guarantee Threshold

IFF submits that the $450 a month threshold of earnings for Superannuation Guarantee contributions should be removed as this currently disadvantages casual and part time workers, many of whom are women. The Standing Committee on Economics, Finance and Public Administration also recommended that the threshold not be increased, and that consideration be given to reducing it.[65]

14.2 Consolidation of Member Accounts

To the extent possible superannuation benefits should be consolidated into one account to reduce the small accounts problem and loss of benefits to members.

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[64] Regulation 7.9.20(1)(l) Corporations Regulations

[65] "Improving the superannuation savings of people under 40" May 2006.

(a) Lost Members

Currently it is up to a member to locate their superannuation moneys through the Lost Members Register. It will be apparent to all concerned that this approach is not working.

The result is that members are losing access to their retirement savings forever or for a period of time during which those savings will be depleted through fees, or if protected or in an Eligible Rollover Fund (**ERF**), will be earning little or no income.

IFF supports pro-active use of the Lost Members Register by Trustees of superannuation funds as a means of amalgamating member accounts. This should take the form of obligations on trustees to promote and facilitate the consolidation of accounts. This could include imposing mandatory requirements to include in periodic statements to members, information about consolidation of accounts.

(b) ERFs

ERFs are obliged to member protect, but have no obligation to actively try to contact members or to transfer a member's accumulated benefit into their active account.

IFF submits that ERFs be required to proactively locate lost members and consolidate accounts into the members' active superannuation account, provided the accounts:

(i) are inactive (and within two years of having received the last contribution); and

(ii) have a balance below the level at which the account can sustain itself (based on actual medium term balanced rates).

(c) Lost Members Register

The Australian Taxation Office (**ATO**) is responsible for managing the Lost Members Register (**LMR**) and IFF submits that the ATO needs to actively and continuously manage the LMR, supported by education and an automatic electronic consolidation processes.

(i) When is a member "lost"?

IFF does not support the reporting of member details to the LMR for members who have been inactive for 2 years or more 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.

(ii) Centralisation

IFF supports one centralised ERF to be used by all superannuation funds to help manage the consolidation of small superannuation accounts and lost member accounts. The ERF would have to be Government run.

(iii) Co-operation between Government and Super funds

In the absence of a centralised ERF, IFF supports the pro-active use of the LMR by superannuation funds as a means of amalgamating member accounts. Legislation should support this access and any legislative impediment (e.g. Privacy Law) should be removed.

14.3 Capital Gains Tax and Fund Mergers

The Government has actively promoted rationalisation of the superannuation industry. Substantial rationalisation has occurred as a direct result of the introduction of APRA licensing. However, further rationalisation is likely, and in some cases desirable.

A significant barrier to merger of superannuation funds is triggering a capital gains tax (**CGT**) liability. Funds contemplating a merger must determine if it will be in the best interests of members of the funds in question. If members will incur a reduction in their account balance due a capital gains tax liability being triggered, trustees may be unable to form the view that a merger is in the best interests of members.

In the environment of fund choice fund mergers where trustees consider them appropriate, should be permitted without triggering a capital gains tax liability. This should apply where there are two separate trustees and also where one trustee has two funds that can be managed more efficiently and cost effectively by being combined.

IFF submits that a permanent exemption should be in place to avoid a CGT liability being triggered by a fund merger. In addition efforts should be made to standardise State legislation dealing with stamp duty, which makes the merger of assets of regulated superannuation funds exempt from stamp duty liability.

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