Inquiry into the Structure and Operation of the Superannuation Industry

Submission to the Joint Committee on Corporations and Financial Services

By
Law Council of Australia (Superannuation Committee)

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Terms of Reference

We refer to the release of 3 July 2006, which attached the following terms of reference:

The Committee will inquire into the structure and operation of the *Superannuation Industry (Supervision) Act 1993* and the superannuation industry to ensure that it provides an efficient, effective and safe regulatory structure for the management of superannuation funds, with particular reference to:

1. Whether uniform capital requirements should apply to trustees.

2. Whether all trustees should be required to be public companies.

3. The relevance of Australian Prudential Regulation Authority standards.

4. The role of advice in superannuation.

5. The meaning of member investment choice.

6. The responsibility of the trustee in a member investment choice situation.

7. The reasons for the growth in self managed superannuation funds.

8. The demise of defined benefit funds and the use of accumulation funds as the industry standard fund.

9. Cost of compliance.

10. The appropriateness of the funding arrangements for prudential regulation.

11. Whether promotional advertising should be a cost to a fund and, therefore, to its members.

12. The meaning of the concepts "not for profit" and "all profits go to members."

13. Benchmarking Australia against international practice and experience.

14. Level of compensation in the event of theft, fraud and employer insolvency.

15. Any other relevant matters.

Although the Law Council of Australia Superannuation Committee (**LCASC**) is interested in all of the areas outlined for this inquiry, it has focused its review on those areas which principally involve consideration of legal issues.

Our comments below follow the numbering in the terms of reference.

1. Whether uniform capital requirements should apply to trustees

1.1 We query the risk/reward analysis undertaken with respect to a requirement for uniform capital requirements. In other words, it is not clear to us what problem would be resolved for the risks and costs required to be incurred. It would seem that "retailisation" of all superannuation funds would be contrary to a policy of offering citizens the widest possible choice in respect to superannuation.

1.2 We also note that this proposal has previously been examined as part of the "Safety in Superannuation" consultation process and was rejected by the Mercer Committee as well as by the Government.

2. Whether all trustee should be required to be public companies

2.1 We see no reason to require a corporate trustee to change its current company structure in the absence of any indication that a public company structure provides benefits to members of the superannuation funds for which the trustee is responsible.

3. The relevance of APRA standards

3.1 We are concerned that APRA is given latitude to impose conditions in the RSE licence which are in addition to those set out in the SIS Act and Regulations.

3.2 The LCASC believes that, as a matter of "good law", the regulator's power and discretion should be controlled by legislation so that APRA is not given the power to make "regulations" on an entity-by-entity basis. In the experience of our members, APRA's standard-making power is exercised by APRA in a way that amounts to imposing new legislative requirements.

3.3 As you may know, the Government specifically rejected the request of the Superannuation Working Group dealing with "Safety in Super" that APRA be given "standard making" power. Therefore, we do not think that it is appropriate that the SIS Act contains general wording which could nonetheless allow this to happen.

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

4. The role of advice in superannuation

4.1 We consider that it would be helpful to permit employers and other non-licensed entities to provide certain information in relation to superannuation

without requiring a licence or other authorisation via an Australian Financial Services Licensee.

4.2 We also note that there is a potential difficulty for funds which do not pay commissions to advisers to have their fund products appropriately considered in financial advice provided to their members. This can lead to financial advisers failing to recognise and advise on features available from such funds.

4.3 We are aware of fund experience that demonstrates members are not willing to pay "fee for service" for financial advice and would prefer to have their advice provided on a commission or other superannuation provider-funded basis. This may have implications for the kind of advice typically provided to members and is dependent upon whether funds can or do offer superannuation provider-funded fees to financial advisors.

5. The meaning of member investment choice; and

6. The responsibility of the trustee in a member investment choice situation

6.1 We made a number of submissions to APRA in relation to the revised APRA Circular on investment choice issued earlier in 2006. We have re-stated some of our submissions below.

6.2 There are conflicting views about whether, in relation to offering member investment choice, the trustee:

(a) is restricted to offering only a range of investment strategies, each of which must meet the requirements of section 52(2)(f); or

(b) can accept directions relating to investment choices, whether or not each choice corresponds to an investment strategy of that kind.

6.3 If view (a) is the correct view, then this implies that diversification is a factor to be taken into account at the strategy level rather than the fund level. Overall, the discussion about strategies in APRA's Circular in the context of member investment choice seems to contain a number of inconsistencies.

6.4 The view expressed by APRA in its Circular is that in formulating its range of strategies, the trustee must ensure that the trustee "retains control of the composition and allocation of fund assets" is not supported by the SIS legislation. It is inconsistent with the ability to offer member investment choice which is provided for in section 52(4) of SIS Act. In this regard, it seems to us that APRA has misconstrued the requirement to take into account the whole of the circumstances of the fund. In a fund which offers member investment choice, the trustee must take that circumstance into account and this implies that the trustee will lose control of the composition and allocation of fund assets which are subject to member investment choice.

6.5 Similarly, consistent with APRA's view that the trustee must take account of members' "expectations", we would argue that if the fund is one in which all members have appointed financial advisers to assist them with their choice of strategy, then this is a "circumstance" of the fund which the trustee can (and indeed, must) take into account in order to comply with section 52(2)(f).

6.6 We strongly disagree with APRA's view that a trustee should impose limits on the ability of members to choose particular strategies in order to control diversification of assets across the fund. It is unclear what benefit is derived, in this circumstance, by achieving fund diversification. Further, we expect that imposing limits would lead to a range of practical problems such as:

- members will already have invested in the fund on the basis that there are no such limits and it will therefore be problematic (and risky for the trustee) to change the existing arrangements;
- members may consider that any strategies that are offered which do not have a limit are 'risk free' strategies;
- introducing systems for monitoring and rebalancing the limits will be costly and disruptive;
- imposing limits on a strategy is unlikely to be of benefit to those members who have already selected that strategy.

6.7 An alternative approach that might be considered in relation to the question of imposing limits is to say that when APRA considers whether or not a particular strategy has been properly formulated, a factor that APRA will consider relevant is whether the strategy is made available to members in an unlimited or limited way. If view (a) (mentioned in paragraph 6.2(a) of this letter) is the correct interpretation, then this would seem to be a factor that the trustee itself should take into account in setting the strategy.

6.8 The diversification of investments of the fund as a whole is irrelevant to an individual member's investment choices. From the fund's perspective, where a member's entitlement is directly attributed to one or more investment choices, the member's entitlements can only be paid from a realisation of those investments. How other members of the fund have invested and the extent of their diversification is irrelevant to that member's entitlements and the trustee's obligation to pay those entitlements.

6.9 At the member level, the question of diversification is not the fund's diversification but, rather, the diversification of the member's superannuation and non-superannuation investments, of which the trustee will have no knowledge.

6.10 APRA's view appears to be that, in the context of beneficiary investment choice, the trustee is in the best position to assess the most appropriate strategy for each member. We consider that the trustee cannot have detailed, or, in most cases, any knowledge of each member's financial circumstances or total investments within (and outside) the superannuation

system and can only be responsible for the choices offered by the trustee and not the choices made by members.

6.11 In our view, with respect to each member investment strategy available for selection, so long as the trustee met its obligations under SIS Regulation 4.02(2) concerning provision of information, the individual member could then make his or her own decision without any further intervention by the trustee.

7. The reasons for the growth in self managed superannuation funds

In the view of the LCASC, the reasons for the growth of the numbers of self managed superannuation funds (SMSFs) are due to the following:

1) the continued promotion of these arrangements by accountants;
2) the relatively low costs associated with establishing an SMSF;
3) the ability to invest in arrangements associated with an employer-sponsor (ie business real property);
4) the ability to maintain SMSFs for successive generations (ie children and grandchildren of the founding members). Put another way, SMSFs tend to hold assets for a number of generations, which accounts for the fact that a low number of SMSFs are wound up relative to those which are established each month; and
5) choice of fund.

8. The demise of defined benefit funds and the use of accumulation funds as the industry standard fund.

8.1 The LCASC notes that funding arrangements from an employer-sponsor's perspective are more certain under an accumulation fund. This factor, coupled with the general inability for employers to offer "choice of fund" where contributions are being remitted to a defined benefit fund, have been strong determinants in employers seeking to restructure superannuation arrangements from defined benefit to accumulation.

8.2 The LCASC also notes that the perceived administrative and cost burden associated with the RSE licensing regime has led many employers to consider winding up corporate superannuation funds (which is typically where defined benefits are offered) and transfer employee entitlements to a master fund arrangement. As part of this process, defined benefits are "crystallised" into accumulation amounts and transferred to the master trust (which maintains benefits on a accumulation basis going forward).

9. Cost of compliance

9.1 There has been significant regulatory change with the introduction of FSR, choice, portability and APRA licensing in the past two to three years. Accordingly, it is likely that compliance costs would have been significantly increased throughout this period. The likely increased day-to-day

compliance costs as part of APRA licensing has been a significant reason for many corporate superannuation funds determining to wind up prior to 30 June 2006. Ongoing compliance cost experience may be a factor in whether further consolidation of the industry occurs.

10. The appropriateness of the funding arrangements for prudential regulation

10.1 We assume this issue refers to the supervisory levy imposed on funds. We do not have any specific comment to make at this stage.

11. Whether promotional advertising should be a cost to a fund and, therefore, to its members.

11.1 In the LCASC's view, advertising is not prohibited under the sole purpose test but, as ASIC's disclosure regime does not require the trustee to advertise, the trustee must be able to justify why it is advertising and why a particular form of marketing was selected – a cost /benefit analysis. In our experience, it is common place for a trustee to undertake this type of analysis before commencing advertising or marketing exercises.

11.2 The trustee must also be mindful of its duties to current members (as opposed to potential members) and be sure that the expense borne by current members is equitable in the circumstances. If a benefit to members can be demonstrated, then the trustee can be justified in incurring the expense. It is also relevant that costs or expenses are not always directly paid by members as often, the amount of the expense is not significant in the context of the size of the fund overall. This will vary from fund to fund.

11.3 Many trustees now believe that in the absence of advertising (in a more "competitive" environment due to fund choice and portability), a fund may be at risk of losing members, and therefore subjecting the remaining members to higher costs.

11.4 Put another way, under this regime, trustees that do not market their superannuation funds may be at risk of losing assets to funds that do engage in advertising.

11.5 "Not for profit" funds can only pay advertising expenses as a cost of the fund, as they have no other source of funds. This contrasts with the position for "institutional" or "for profit" funds which are operated for the purpose of making a profit for the organisation that owns or promotes them and therefore typically that organisation has its own funds to spend on advertising its product range including superannuation. A limitation or prohibition on advertising as a cost of the fund will necessarily have the effect of limiting or prohibiting advertising in one part of the superannuation industry (the "not for profit" sector) while having no impact on advertising by the "for profit" sector. We query whether this result is beneficial to the industry.

12. The meaning of the concepts "not for profit" and "all profits go to members".

12.1 The LCASC notes there are a number of key divisions which regulate advertising of financial services: including section 1018A of the Corporations Act, section 1041E of the Corporations Act, section 1041F of the Corporations Act and section 12DA of the Australian Securities and Investments Commission Act 2001 (Cth).

12.2 In relation to those provisions which impose an obligation on trustees not to engage in misleading and deceptive conduct in relation to “financial services” (ie the provision of superannuation entitlements in their fund), the LCASC notes that there is substantial case law which highlights the need for representations in advertising material to be properly tested.

12.3 Where representations concern predictions as to future matters, the LCASC notes that the person making such a representation must (if challenged) demonstrate the grounds for making such a statement.

12.4 The LCASC notes that any particular representations by a superannuation fund trustee regarding security, profitability, financial performance, fee structure and commission arrangements should be properly tested to avoid the risk that such statements are misleading and deceptive or could potentially mislead or deceive the target audience for those statements.

12.5 In terms of references to "not for profit" or "profit for members", the LCASC notes that these representations are typically made where the trustee is owned or the fund is promoted by non-profit organisations - which do not receive a return from the operation of the fund (contrasted with the "retail" sector where the trustee is typically owned by an organisation which pays dividends to shareholders).

12.6 The LCASC also notes that the concept of “profits” in the superannuation context may be difficult to apply. Typically the reference to “all profits to members” is a reference to the fact that there are no payments to related parties or financial advisers involved in the “selling” of an interest in the relevant superannuation fund – which may in fact be a valid statement.

12.7 Accordingly some precision may be required to distinguish this concept from that whereby a profit is derived as a result of trading activities, which is not necessarily relevant in the superannuation context. Superannuation funds do not typically operate as a “business” with a profit expectation.

12.8 The LCASC also notes that the distinction highlighted by this issue (ie the divide between industry and institutional funds) raises related questions of ensuring effective competition in the APRA regulated superannuation industry - especially in a “choice” environment.

12.9 To limit advertising for one sector of the industry may not be beneficial.

13. Benchmarking Australia against international practice and experience

13.1 This term of reference is difficult to respond to as it is so broad and gives rise to the question: "benchmarking what?" against international practice and experience.

13.2 The LCASC is aware that the International Pension and Benefits Lawyers Association (IPEBLA) is presently conducting an international survey (which will be published in the next 6 months) concerning the superannuation and pension regimes of many countries. This survey may be of assistance and we can arrange to have a copy made available to the Committee if it would be useful.

14. Level of compensation in the event of theft, fraud and employer insolvency

14.1 The potential scope for comment on this issue is broad.

14.2 Many funds have fidelity insurance cover, but there are no set criteria for how members may be dealt with in the event of fraud or theft – it would be dealt with as a matter of law depending upon the perpetrator of the fraud and the extent of the loss.

14.3 Whether or not employers should also be required to have fidelity cover or to be specifically protected under a fund's fidelity cover is a difficult question and one that would need to be addressed with the insurance industry in terms of the likely costs and outcomes that could be realistically achieved.

14.4 Recent requirements for regular payment of employer contributions (including quarterly SG shortfall reporting) and reporting to members/employees should to some extent have ameliorated issues surrounding employer insolvency.

15. Any other relevant matters

15.1 The LCASC notes that there are a number of other key areas which ought to be addressed as part of any inquiry into the current state of the superannuation industry.

15.2 We note that although the preamble to the terms of reference suggests inquiry into the effective operation of the SIS Act, we suggest that it should also include relevant provisions of the Corporations Act and other regulation directly affecting superannuation funds.

15.3 Although the LCASC notes there has been considerable consolidation of APRA regulated superannuation funds as a result of the requirement to hold an RSE licence from 1 July 2006, it is also important to note that the number of professional administration companies servicing these superannuation funds is also declining. The LCASC also believes that case is the same with respect to the provision of custodial services to APRA regulated superannuation funds.

Attachment A

Profile – Law Council of Australia

The Law Council of Australia is the peak national representative body of the Australian legal profession. The Law Council was established in 1933. It is the federal organisation representing approximately 50,000 Australian lawyers, through their representative bar associations and law societies (the "constituent bodies" of the Law Council).

The constituent bodies of the Law Council are, in alphabetical order:

- Australian Capital Territory Bar Association
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society of the Australian Capital Territory
- Law Society of the Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- The Victorian Bar Inc
- Western Australian Bar Association

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