



16 May 2012

The Manager  
Superannuation Unit  
Financial System Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email: [strongersuper@treasury.gov.au](mailto:strongersuper@treasury.gov.au)

Dear Sir,

**Exposure Draft – Further MySuper and Transparency Measures Bill**

I am pleased to enclose a submission prepared by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia on the exposure draft of *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012*.

The Committee would welcome the opportunity to discuss its submission further. In the first instance, please contact the Chair of the Committee, Ms Heather Gray on (03) 9274 5321 or at [heather.gray@dlapiper.com](mailto:heather.gray@dlapiper.com).

Due to time constraints this submission has not been considered by the Directors of the Law Council of Australia.

Yours sincerely

*Margery Nicoll.*

**Margery Nicoll  
Acting Secretary-General.**

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# Exposure Draft – Further MySuper and Transparency Measures Bill

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## The Treasury

**Submission by the Superannuation Committee of the Legal Practice Section of the  
Law Council of Australia.**

**16 May 2012**

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## 1 About the Law Council of Australia, Superannuation Committee

- 1.1 The Law Council of Australia is the peak national representative body of the Australian legal profession, and represents about 56,000 legal practitioners nationwide. This submission has been prepared by the Law Council of Australia's Superannuation Committee, which is a committee of the Legal Practice Section of the Law Council of Australia. The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. The makes submissions and provide comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

## 2 Outline of submission

- 2.1 The Committee has provided a summary of its submission in this document. The Attachment sets out more detail about particular topics.
- 2.2 The Bill contains seven schedules. The Committee's comments on the Bill are organised in the same order as the schedules to the Bill.

## 3 Schedule 1 - Fees and costs

### ***MySuper members must not bear costs associated with conflicted remuneration***

- 3.1 The Committee has a number of concerns about proposed section 29SAC(1) of the Superannuation Industry (Supervision) Act 1993 (SIS Act). This provision sets out the conditions which a trustee must satisfy in order to make an election as part of their MySuper authorisation application. If a trustee makes the election (as they will be required to do in order to receive their MySuper authorisation) they will undertake not to charge MySuper members a fee which directly or indirectly relates to costs incurred by the trustee in paying conflicted remuneration to a financial services licensee or to a representative of a financial services licensee *or to another person who will in turn pay conflicted remuneration to a financial services licensee or to a representative of a financial services licensee*: see proposed section 29SAC(1)(a)(i) and (ii).
- 3.2 The Committee considers that the election process is inappropriate. It also considers that the provision will detrimentally affect trustees (and thereby fund members) where:
- (a) they have continuing obligations to pay conflicted remuneration under grandfathered arrangements; or
  - (b) they are unaware and could not reasonably be expected to be aware that the recipient of a payment from the trustee uses the payment to pay conflicted remuneration.

### Elections and paragraph 51(xxxi) of the Constitution

- 3.3 The Committee is also concerned about the effective requirement for trustees to "elect" to do certain things – in this case, to not charge fees relating to paying conflicted remuneration but also in proposed section 29E(6A) of the SIS Act to transfer accrued default amounts. It appears that this approach may be an attempt by the Government to avoid the question of whether a particular provision

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could breach the requirement under paragraph 51(xxxi) of the Constitution with regard to any acquisition of property having to be made on just terms. If a trustee elects to give up their property, it might be said that there has not been an acquisition of that property by the Commonwealth and thereby the power under section 51(xxxi) is not enlivened. However, the relevant cases state that the question of whether there has been a breach of this prohibition is a question of substance not form and so, for example, the majority in the High Court in *Georgiadis v Australian and Overseas Telecommunications Corporation* (179 CLR at 305) say “It is often said in relation to constitutional guarantees and prohibitions that ‘you cannot do indirectly what you are forbidden to do directly’”.

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

#### Ongoing obligation to pay conflicted remuneration

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

#### Trustee unaware that a payment is used to pay conflicted remuneration

- 3.6 Trustees will be required to ensure that MySuper members do not bear any costs attributable to amounts which have been paid by the trustee to another person, in circumstances where the other person pays conflicted remuneration to a financial services licensee or to a representative of a financial services licensee. This may have unfair consequences in cases where trustees make a payment to a person without any reasonable knowledge that the recipient has subsequently used part of this amount to pay conflicted remuneration to a third person. Trustees should be protected in cases where they had no knowledge of the conflicted remuneration and could not have reasonably known about the conflicted remuneration arrangements.
- 3.7 An example would be the arrangements between some institutional investment managers who act for superannuation funds and the intermediaries who first introduced the investment manager to the superannuation fund. Anecdotally, it is understood that, in particular cases, a significant proportion of the investment management fees paid by a superannuation fund might, in turn, be paid by the investment manager to the intermediary who first introduced the investment

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manager and the superannuation fund. Such payments (i.e. by the investment manager to the intermediary) would arguably constitute conflicted remuneration, especially given the proposed modifications to the definition of conflicted remuneration. However, it is unlikely that superannuation fund trustees would be in a position to know whether or not such arrangements exist and, even if a trustee objects to such an arrangement, it will be difficult to prevent the payments from occurring. As such, it would be unfair for a trustee to be penalised through the loss of its MySuper RSE authorisation on account of an investment manager choosing to pay part of its investment management fees to a third party in the form of conflicted remuneration.

- 3.8 The Committee suggests that section 29SAC should be re-worded so that subparagraph 29SAC(1)(a)(ii) is not contravened in circumstances where the trustee is not aware of the payment or could not have reasonably been aware of the payment, for example, where the trustee can demonstrate that the investment management fees were the same as they would have been even if there was no conflicted remuneration (for example, by comparison to other investment managers responsible for managing similar kinds of portfolios).
- 3.9 A more common (but similar) scenario is where offshore investment managers (often boutique managers or those specialising in a particular sub-sector within an asset class) have chosen not to establish an Australian presence and instead operate through 'third party distributors' or 'third party marketers' who *are* based in Australia and who are naturally remunerated for their services. Unless a suitable exemption is created, the proposed legislation would potentially prevent Australian superannuation funds from having access to specialist investment managers who have chosen to conduct their business on this basis, given that the payment of investment management fees could put trustees in breach of the legislation.
- 3.10 Finally, the Committee notes that the provision will not preclude the payment of amounts which are analogous to conflicted remuneration being made to persons who are *not* financial services licensees or their representatives – such as persons acting in a similar role in foreign jurisdictions and who therefore do not hold an Australian financial services licence. This would seem to be an anomalous result.

#### ***Performance-based fees***

- 3.11 The performance based fee provisions are to take effect from 1 January 2013 or any earlier date specified by proclamation. The Committee is concerned that this timeframe does not provide sufficient time for trustees to renegotiate existing arrangements and, further, would require those renegotiations to take place part way through a performance period which could be detrimental for trustees if investment managers insist on crystallising a performance fee for their short-term performance during the six months between 1 July 2012 and 1 January 2013. The Committee is also concerned that foreign investment managers, in particular, are likely to be unwilling to consider requests to renegotiate existing contracts over a short time-frame. The Committee considers that there needs to be a generous transition period provided in order to provide trustees and investment managers with sufficient time to negotiate new terms. It also considers that an exception to the provisions should be provided for existing arm's length arrangements where termination has adverse consequences for the fund and would not be in members' interests.
- 3.12 The Committee also has specific concerns about some of the performance fee criteria. These are set out in the Attachment.

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### ***Operating standards***

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

### ***General fee rules***

- 3.14 The Committee notes that the general fee rules apply to all regulated superannuation funds other than self-managed funds and across both choice and MySuper products.
- 3.15 The proposed definition of “switching fee” (see proposed section 29V(5)):
- (a) overlaps with the concept of buy/sell spreads (since buy/sell spreads are also designed to capture the costs of deploying/liquidating the cash flow associated with switching activity);
  - (b) only captures switches between classes of beneficial interest, but does not capture (and therefore does not limit) fees which may be charged for switching between investment options within the same class.

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

### ***Definition of “entry fees”***

- 3.16 The proposed legislation would prohibit the charging of entry fees in relation to superannuation funds. However, the definition of “entry fees” overlaps with the definition of buy/sell spreads. This is problematic, because it gives rise to an ambiguity and inconsistency as to whether or not a trustee can charge a buy/sell spread to cover the costs of investing the first contribution that is made on behalf of a member at the time of entering the fund. The Committee suggests that this definition should refer to a fee (other than a buy/sell spread) that relates to the issuing of a beneficial interest in a superannuation entity to a new member.
- 3.17 The Committee notes that section 99E will introduce a statutory obligation for trustees to ensure that costs are attributed between different classes of beneficiaries ‘fairly and reasonably’. This obligation differs from the equitable obligation (and proposed new covenant) to treat different classes of beneficiaries fairly by introducing a ‘reasonableness’ component. The EM does not provide any explanation for this difference.

### ***Financial advice to employers***

- 3.18 Under proposed section 99D there will be a prohibition on the cost of financial advice provided to an employer of one or more members of the fund from being

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recovered directly or indirectly through a fee charged to any member of the fund. The prohibition applies to the provision of both general and personal advice to employers.

- 3.19 The Committee notes that it is a policy matter for Government whether to impose a prohibition of this kind. Nevertheless, it wishes to draw attention to the particular and possibly unintended impact this provision may have on corporate and industry superannuation funds. Sponsoring employers will often rely on advice from they are given from a superannuation fund trustee about matters such as how to comply with their superannuation obligations and legislative changes with regard to the particular features of the fund. This is particularly likely in the case of employers who are participating in defined benefit funds where their obligations may be more onerous. In many cases, the advice will involve a mixture of factual information and financial product advice. It may also include advice that is provided in the context of the trustee fulfilling regulatory requirement with regard to notifying employers about certain matters, for example, in connection with fund solvency. It may be difficult for trustees to distinguish and may have adverse consequences for the trustees being able to freely communicate with employers. Further, this provision will adversely impact the close working relationship that a trustee will often have with its employer-sponsors and this in turn will be detrimental to their employees who are the members of the fund. The Committee queries whether trustees of superannuation funds should be able to provide both factual information and, at least, general advice to employers, without having to try to identify the specific costs of so doing and with the cost of both being able to be charged collectively across the members of the fund.

#### ***Cost of financial product advice***

- 3.20 Proposed section 99F will prohibit the cost of particular kinds of personal advice being charged to members of the fund as a whole and requires the cost of that advice to be met by the member to whom the advice is given. The advice to which the provision is directed appears to be “intra-fund advice”. However, this is not expressly stated. The Committee notes there is a great deal of misunderstanding about what advice is permitted to be given by trustees. A provision dealing with charging for advice, in the absence of provisions dealing with the provision of the advice itself, is contributing to that confusion. Minister Shorten released a statement on 8 December 2011 announcing an extended range of matters which would be considered “intra-fund” advice. To date, trustees have not been given any relief to enable them to provide that advice. Without draft legislation dealing with intra-fund advice, it is difficult to comment on provisions which deal with charging for that advice. The Committee considers that the Bill and Explanatory Memorandum should deal with advice given by trustees to their members, including intra-fund advice in a comprehensive manner.
- 3.21 As to the detail of the provision, the proposed legislation would protect the general membership from the cost of advice which has been given to a particular member to assist them with directing the trustee to invest “in a specified financial product”. The Committee is concerned that the precise scope of this provision is unclear. Is it intended to apply only where the fund is in the nature of a “super wrap” (where all of the available investment options are financial products in their own right) or is it also intended to apply where the fund offers members a limited range of “investment options” some of which may be financial products in their own right? If the latter, this would be very difficult to administer as a trustee would need to track which advice relates to which investment option.

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- 3.22 Many investment options within a superannuation fund are generally not regarded as financial products in their own right. As such, the legislation would not prevent a trustee from charging the general membership for the costs of advice provided to members to assist them in choosing between investment options offered within the fund.
- 3.23 However, in other cases, investment options may constitute a financial product. This is commonly the case where, for example, a trustee offers ethical investment options and chooses to do so by offering investment in an ethical fund that is itself a financial product. Also, how does the provision apply when all investments are made through an interposed vehicle such as an investment policy (again where the investment policy is itself a life insurance product)?
- 3.24 The draft Explanatory Memorandum (at paragraph 1.41) suggests that the reason for this prohibition is to exclude more complex advice. However, it is not readily apparent that an investment option is more complex merely because it is comprised of a particular financial product.

#### **4 Schedule 2 – Provision of benefits**

- 4.1 The proposed legislation would require trustees to “ensure” that their fund “provides” death and permanent incapacity benefits and that these benefits are “provided by taking out insurance”. It is unclear from the drafting whether a trustee would be in breach of these obligations if, through no fault of the trustee, the insurer failed to honour the insurance policy (e.g. in the event of insolvency or other default). A trustee ought not to be in breach of the legislation in such circumstances. Therefore, the Committee suggests that the Bill be amended to include a provision which deems a trustee to comply with its obligations under the insurance provisions if the trustee holds an insurance policy in accordance with the provisions.
- 4.2 The Committee notes that proposed section 68AA(6) also appears to apply to existing members of the fund. Trustees who negotiate insurance cover for existing members (and new members) should also be protected from liability in the event that a member complains about the cost of the insurance cover or any detrimental impact taking out that cover has on the member’s existing cover. The Committee notes for example that many policies provide for the sum insured to be reduced by cover provided under another policy held for the person.
- 4.3 The proposed section does not have regard to the terms of insurance policies which currently provide death and disablement benefits. Many policies are written and priced on the basis that a member may have death only insurance or bundled death and disablement insurance. A fund’s policy may not be written and priced to allow a member to opt out of either of these insurances.
- 4.4 Further, it is proposed that an operating standard will be made to limit trustees to only taking out risk insurance policies for the provision of insured benefits that satisfy the conditions of release in the Superannuation Industry (Supervision) Regulations 1994 (Cth) (SIS Regulations) for death, terminal medical condition, permanent incapacity and temporary incapacity. Again, many policies will not be written and priced in accordance with this standard and will need to be re-negotiated.
- 4.5 As insurance policies held by superannuation funds are generally group policies, re-negotiation of these policies mid-term will involve re-rating the cost of insurance

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for all members covered by that policy. Further, all superannuation funds affected by these issues will be looking to renegotiate their terms (often with the same insurers) at the same time. To avoid potential detriment to members, the Committee suggest that these standards apply at the earliest date (after the commencement date) on which the trustee re-negotiates the terms of its insurance policies.

## 5 Schedule 3 – Collection and disclosure of information

### *Product dashboard*

5.1 The proposed sections 1017BA(2) and (3) require product dashboards to include details of “the average amount of fees charged in relation to the product, on a per member basis” which must be up-to-date at all times. It is unclear from this drafting what must be disclosed and, depending on the intended meaning of this drafting, it may be impossible for trustees to comply with the requirement. For example:

- (a) it will be impossible for trustees to disclose a single average amount, expressed in dollars, since many fees are calculated as a percentage of a member’s account balance or as a percentage of the amount invested in a particular investment option;
- (b) it will be impossible for the average to be up-to-date at all times, because the costs incurred by a fund (and which are in turn borne by members) change constantly in real-time. For example, fees paid to external managers are typically calculated as a percentage of the portfolio value, and portfolio values fluctuate constantly in line with market movements.

However, trustees *would be able* to include the following information in product dashboards:

- (i) *the indirect cost ratio (ICR) applicable to the investment option, in percentage terms, as at the preceding 30 June, consistent with what is currently disclosed in product disclosure statements (noting that the ICR is inherently an historical figure and that it does not include administration fees or dollar-based fees and charges); and/or*
- (ii) *other fees and charges (some of which may be disclosed in dollar terms and others on a percentage basis), noting that it would not be appropriate to aggregate these and that each fee or charge would be separately listed; and/or*
- (iii) *the worked-example of fees and charges which is disclosed (or incorporated by reference) in the relevant product disclosure statement.*

5.2 Proposed sections 1017BA(2) and (3) should also be drafted with more precision and greater consistency. For example:

- (a) the proposed sections 1017B(2)(a) and 1017B(3)(a) refer to the investment return target “for the product” (and it should be noted that investment options are not generally regarded as separate financial products in their own right); whereas

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- (b) the proposed sections 1017B(2)(b), 1017B(2)(c), 1017B(3)(b) and 1017B(3)(d) refer to past performance and risk associated with “those assets” (which is a confusing change in terminology from the preceding paragraph); and
  - (c) the proposed sections 1017B(2)(d) and 1017B(3)(d) refer to the liquidity of members’ investments in the product / investment option.

The terminology would ideally be harmonised across these proposed sections.

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

***Obligation to publish information about underlying holdings***

- 5.4 The Committee is particularly concerned about the complexity and uncertainty of the drafting of proposed section 1017BB of the Corporations Act and the difficulty for trustees in trying to comply with it. The term “assets derived from assets” is very unclear. A lack of clarity in the provision will cause real difficulties for trustees in trying to comply with it.
- 5.5 The Committee notes that the provision seeks to introduce a fairly simple concept – the disclosure of funds’ portfolio holdings, but considers that there would be numerous legal and practical difficulties in complying with the obligation in its current form. There are also risks for trustees. They include:
- (a) the potential for the holdings data to constitute an endorsement of the securities held, and therefore financial product advice, possibly in breach of licensing requirements;
  - (b) breaching contractual restrictions imposed by existing data licensing agreements which have been entered into with benchmark manufacturers (such as MSCI, Standard & Poor’s and FTSE) which would prevent assets held by passively managed options being disclosed if this would reveal the composition of the relevant benchmark;
  - (c) problems with trying to obtain information from third parties;
  - (d) a lack of clarity in knowing how many levels of investments they need to disclose;
  - (e) the potential to mislead members by disclosing multiple, overlapping layers of investments and possible ‘double-counting’; and

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- (f) significant issues of valuation due to the effect of currency hedging and derivative exposures.
- 5.6 Some investment options offered by large superannuation funds could have exposure to many thousands of underlying securities and the Committee queries whether it would be more useful if trustees were only required to disclose, say, the top 20 or top 50 investments in percentage terms.
- 5.7 Some of the key difficulties and risks are summarised further in the attachment.

***Regulations may require public disclosure of actuarial reports***

- 5.8 The Explanatory Memorandum foreshadows that regulations will require actuarial reports for defined benefit funds to be published on fund websites. The Committee queries whether it is necessary (or appropriate) for actuarial reports to be published on public websites or whether it is sufficient for the reports to be made available to members on a part of the website which can only be accessed by members. It may be more helpful if certain distilled key features from the current/latest actuarial report were required to be disclosed on the website.

***Providing information to a trustee***

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

***Publication of remuneration***

- 5.10 Proposed section 29QB(1)(a)(i) of the SIS Act will require publication of the remuneration of each director and other executive officer of the RSE. It is unclear whether this requires publication of information about remuneration paid by the RSE licensee or any remuneration received by the person, irrespective of its source. This should be made clear.
- 5.11 The Committee notes that this requirement would seem to go further than analogous Corporations Act requirements for disclosure of the remuneration of public company officers in 'bands'.

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### **Quarterly reports published by APRA**

- 5.12 Proposed section 348A of the SIS Act will require APRA to publish certain information about MySuper products. The obligation does not apply to the extent that its operation would result in an acquisition of property other than on just terms. As stated above, the Committee considers that Government should take a view as to whether a particular provision of the law would breach paragraph 51(xxxi) of the Constitution or not. It is not acceptable to leave it for trustees and their advisers to form a view on this with the possibility of then having to carry out an expensive challenge, in this case, regarding publication of fund material by APRA.

## **6 Schedule 6 – Moving accrued default amounts**

- 6.1 These provisions require a trustee applying for a MySuper authorisation to “elect” to transfer accrued default amounts of members to a MySuper product in the same fund or in a different fund offered by the trustee. The Committee noted above (see paragraphs 3.3 and 3.4) its concerns with the constitutional validity of such provisions. Those comments apply equally to the way the Bill deals with accrued default amounts.

### **Definition of accrued default amount**

- 6.2 Proposed section 20B of the SIS Act will provide that an amount is an “accrued default amount” if the investment option under which the underlying assets are invested is the default investment option.
- 6.3 The draft Explanatory Memorandum states that “the term therefore captures amounts where the member has explicitly or implicitly directed that the amount be invested in the fund’s default investment option”. The rationale for this being that the member has “explicitly chosen to delegate responsibility for investment decisions to the trustee”. The Committee considers this statement to be patently incorrect. A member who chooses a default option does not “delegate responsibility for investment decisions to the trustee” but rather decides that they want to invest their superannuation (or a part of it) in the manner which is described in the fund’s PDS as applying to the default option.
- 6.4 The Committee considers that members who have *chosen* a default option should be distinguished from members who have not made an investment choice. Members who have chosen the default option should not be moved to a MySuper product.
- 6.5 Further, the Committee queries the relevance of a member’s investment option in determining whether they should be moved to a MySuper product. Proposed section 29WA of the Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2011 provides that contributions received by a fund after 1 October 2013 for a member who has selected a fund at any time or an investment option (before 1 July 2013) are not required to be paid to a MySuper product. It is not clear to the Committee how from a policy perspective an election by a member for their contributions to be invested in a choice product can be valid for the purposes of proposed section 29WA, but insufficient for the purposes of avoiding an automatic transfer under the accrued default amount provision. The Committee therefore recommends that the definition of accrued default amount exclude amounts covered by an election for the purposes of section 29WA such that there is a consistent policy approach.

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- 6.6 In the Committee's opinion, a member who has chosen a fund should not have an accrued default amount and should not be moved to a MySuper product (either within or outside their chosen fund). If the Government does not adopt the Committee's recommendation on this point, trustees should be given statutory immunity in the event that they transfer a member's benefit to a MySuper product in accordance with the rules. Further, the legislation should compel trustees to transfer these accounts on the basis that such compulsion applies notwithstanding any contrary intention of the member or any contrary provision of the governing rules of the fund or any other duty of the trustee.

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## Attachment

### 1 Performance Fees

#### *General comments on scope of provisions and transition*

- 1.1 It is currently proposed that the requirements relating to performance fees take effect from 1 January 2013 or any earlier date specified by proclamation. While this is a satisfactory lead time for any new performance arrangements entered into after the commencement date, this is unlikely to be sufficient time for trustees to renegotiate existing performance fee arrangements with their incumbent investment managers.
- 1.2 Large superannuation funds may have arrangements with a large number of investment managers (e.g. fifty or more) and most would justifiably postpone commencing renegotiations until after the legislation is finalised and passed. This would mean that trustees would likely only have a few months to conclude a large number of negotiations.
- 1.3 The other factor to be borne in mind is that performance fees are often calculated on the basis of a financial year (ending 30 June) for good reason. These requirements would involve changing the basis on which performance fees are calculated, part way through a performance period, which may be undesirable and complicated. For example, the most convenient way to implement the change might be to bring an early-end to the performance period so that fees can be calculated “pre-change”. However, this would involve investment managers being remunerated on the basis of short term performance (or at least, shorter-than-normal term-performance), which is contrary to the spirit of the legislation.
- 1.4 It should also be borne in mind that foreign investment managers may be less inclined (and in no hurry) to entertain requests to renegotiate existing performance fee arrangements if they have very few Australian superannuation funds as clients.
- 1.5 The requirements relating to performance fees will only apply to arrangements with “investment managers”, which is a term with a defined meaning in the SIS Act. As such, the requirements would not apply to performance arrangements that apply in the following contexts:
  - (a) Investments in pooled funds, such as managed investment schemes and private equity funds; and
  - (b) Investment advisers and asset consultants who advise in connection with particular transactions or at an asset class level, but who fall outside the definition of ‘investment manager’ because they do not actually make discretionary buy/sell decisions in relation to assets held by the superannuation fund.
- 1.6 If the requirements were extended so as to apply to performance fees deducted from pooled funds, which might be justified on grounds of consistency, this would pose an even greater transitional burden on trustees, since the performance fees (which are ultimately borne by trustees) are set pursuant to arrangements between the pooled fund (e.g. the responsible entity of a managed investment scheme) and

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the relevant investment manager. Since trustees are not privy to those arrangements or negotiations, they would have no capacity to affect those negotiations or the basis on which performance fees are calculated.

### ***Comments on specific criteria***

- 1.7 In proposed section 29VC(3), it provides that if a fee in addition to a performance-based fee is payable to an investment manager, that other fee must be set or adjusted so that it is lower than it would be if the arrangement did not include a performance-based fee. The Committee submits that the drafting of this provision should also deal with the situation where an investment manager only ever conducts business on the basis of having management fees *and* performance-based fees. That is, in this case, it will be impossible for the manager to set the management fee at a lower level than it would otherwise be, because the arrangement always includes the performance-based fee. Perhaps in that case it goes without saying that the management fee would be higher if there were no performance-based fee (and therefore the converse is true whereby the management fee is lower because there is a performance-based fee), but that should be clarified.
- 1.8 The requirement that performance fees must be calculated on an after-fees basis ought to be more flexible, in order to accommodate arrangements which require a hurdle return to be achieved before performance fees become payable (i.e. to allow flexibility in cases where the hurdle return has been deliberately set with regard to the fact that performance fees are notionally calculated on a before-fees basis). It is a relatively common compromise for trustees and investment managers to agree that performance fees can be calculated on a before-fees basis, provided that the hurdle return is increased by an amount corresponding to the rate of fees being charged. In dollar terms, this results in the performance fees being the same as they would have been, if the performance fees had been calculated on an after-fees basis (but with a lower hurdle).
- 1.9 The legislation should also clarify that performance fees only need to be calculated before-base fees. If performance fees have to be calculated after base fees and after performance fees, this gives rise to a mathematical circularity.
- 1.10 The requirement that performance be measured by comparison with the performance of a similar kind should also allow for flexibility in certain cases. For example, in the case of investment mandates relating to relatively unusual (or specific) asset classes, it is often considered appropriate to have regard to performance of the asset class which the trustee would otherwise have invested in. For example, if a trustee elects to divert funds away from listed equities to unlisted infrastructure, it would not be unusual for performance of the unlisted infrastructure investments to be assessed by comparison with the performance of a listed equities benchmark, even though these are different kinds of investments. The proposed section 29VC(5) should therefore allow for comparisons to be made against “investments of a similar kind or a reasonable alternative to or proxy for those investments”.

## **2 Disclosure of portfolio holdings**

### ***Publication***

- 2.1 There is a very real risk that members of the public will interpret holdings data as a recommendation of the various stocks which are listed in proportions which are

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

- 2.2 Disclosing holdings on a look-through basis raises a serious issue of double-counting and meaningful disclosure. For example, the proposed section 1017BB requires disclosure of “each” of the financial products in which superannuation funds have invested and “each” of the financial products in which assets derived from the superannuation fund have been invested. For example, if a superannuation fund invests \$10M into Managed Fund A, and Managed Fund A invests \$10M into BHP Billiton, the proposed legislation would require disclosure of both the \$10M worth of units in Managed Fund A, as well as the underlying exposure to \$10M in BHP Billiton. This may lead members to suggest that there are \$20M worth of assets in total, whereas this is not true, but rather a case of double counting (and there is obviously the chance of triple-counting or quadruple-counting depending on how many layers of vehicles there are). However, it would be dangerous to address the risk of double-counting by focussing only on the underlying holdings and not disclosing the interposed vehicles, because this would mislead members as to where the fund’s assets have been invested and the associated risks. For example, if a superannuation fund had invested \$100M in Trio Capital which had in turn reported that it had invested the \$100M into underlying assets, the proposed legislation could give rise to serious allegations by members that they had been misled if the interposed vehicle were to collapse (like Trio Capital) and members were unaware that they had any exposure to the collapsed vehicle as a result of the legislation focussing only on underlying holdings.
- 2.3 The proposed legislation seems to focus mainly on investments in equities and managed funds that invest in equities. However, superannuation funds invest across various asset classes, including cash, fixed interest and property. For example, superannuation funds are increasingly investing in debt markets and are acquiring hybrid securities and other fixed interest securities. A question arises as to whether the look-through applies to debt securities, for example, securitised holdings, whereby moneys which are invested (ostensibly on loan) are in turn used to invest in other securities, and which are often backed by the resulting pool of securities (e.g. in the case of mortgage backed securities). Consideration should be given to whether exposures to particular counterparties should be aggregated. For example, if a superannuation fund holds \$50M worth of Westpac shares, \$30M of Westpac hybrid debt securities and \$20M in Westpac term deposits, and has a \$100M exposure to Westpac for currency hedging purposes, how should this be disclosed: should each holding be disclosed individually or on an aggregated basis, to best reflect the fund’s exposure to Westpac?

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- 2.4 Large superannuation funds have exposure to a large number of securities, especially for options that have an allocation to international equities and/or which have portfolios managed on a passive basis (i.e. because those portfolios would include exposure to virtually all the securities in the relevant benchmark index which the portfolio tracks). It would not be unusual for a large superannuation fund to have exposure to more than 5,000 securities. The Committee queries the practicality and usefulness of publishing a list which contains over 5,000 entries on a website.
- 2.5 The Committee queries the usefulness to members of disclosing the number of shares and the price per share, as contemplated by the Explanatory Memorandum. Disclosing the price per share raises a separate question as to how international holdings should be quoted (i.e. in Australian dollars or in native currencies).
- 2.6 In light of the above, assuming that there is to be an obligation to disclose underlying portfolio holdings, the Committee queries whether it would be more useful to disclose:
- (a) only the top 20 or top 50 holdings and;
  - (b) the percentage of the relevant option's assets which has been invested in those securities (rather than the number of shares and price per share).
- 2.7 In any event, the fact that different funds hedge their foreign currency exposure differently and how this affects the disclosure of underlying holdings also needs to be considered. To illustrate the significance of the point, take a simple example involving two superannuation funds.
- (a) Let's say both superannuation funds (each with \$100M in assets) choose to invest \$50M into an Australian ETF and \$50M into a US ETF on 1 January, and for simplicity, assume that 1 AUD = 1 USD at this time.
  - (b) Assume that superannuation fund #1 fully hedged its currency risk, but that superannuation fund #2 did not hedge any of its foreign currency risk.
  - (c) On day 1, both funds would report that they held 50% of their assets in the Australian ETF and 50% of their assets in the US ETF.
  - (d) If equity markets were totally flat for the next 6 months, at the next 30 June reporting date, each fund would still have 50M AUD invested in the Australian ETF and 50M USD invested in the US ETF.
  - (e) However, if currency markets moved 10% during that market, such that \$1 AUD = \$1.10 USD at the 30 June reporting date, the value (in Australian dollars) of the investment into the US ETF would be significantly different for the two funds. Because superannuation fund #1 had fully hedged its currency risk, the value of its investment in the US ETF would still be \$50M AUD. However, for superannuation fund #2, the value of its investment into the US ETF would be only \$45M AUD. Superannuation fund #1 would still report that it had invested 50% of its assets into the Australian ETF and 50% into the US ETF. However, for superannuation fund #2, it is unclear whether it should disclose a 50/50 allocation, or that it had invested 53% of its assets into the Australian ETF and only 47% into the US ETF.

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- 2.8 The use of other kinds of derivatives also needs to be considered, such as the use of SPI futures to equitise cash and holdings of call options and put options. For example, if a fund has \$100M to deploy into the Australian equities market, it can either acquire physical holdings of shares or, alternatively, buy \$100M of Australian SPI futures. In the case of the latter, is it the intention that superannuation funds report their indirect effective exposure to each of the stocks in the index (since the performance of those stocks is what will drive the performance of the SPI futures position), or is it the intention that futures positions be disclosed separately? The same ambiguity would arise when superannuation funds sell down exposure to a market by selling SPI futures (rather than immediately selling their physical holdings). In this case, funds would be overstating their position if they simply disclosed their physical holdings without adjusting for the (short) futures position. Holdings of call options and put options over particular stocks raise similar issues.
- 2.9 Some superannuation funds offer investment options which are entirely (or substantially) managed on a passive or indexed basis. This means that the holdings of the investment option would closely mirror the composition of benchmark indices. In almost all cases, the relevant benchmark licensing agreements (which are usually governed by New York law) would include strict confidentiality provisions which prohibit the disclosure of information concerning the composition of the benchmark, since this constitutes valuable proprietary information of the benchmark manufacturer (for example, MSCI, FTSE or Standard & Poor's). As such, compliance with the proposed legislation would cause some superannuation funds and their trustees to breach the terms of their licensing agreement, exposing them to the risk of termination of the relevant agreement (which would affect the ongoing management of the relevant investment option) and the risk of being sued for damages for breach of contract. The fact that the legislation allows for a 60 day lag following each 30 June and 31 December does not address the breach of contract and third party liability issues. The legislation should therefore include an additional defence for trustees who did not comply with the reporting obligations on account of third party contractual restrictions. Analogous difficulties will arise in the case of ETFs (exchange traded funds), which are predominantly operated as indexed funds and passively managed. The operators of these funds are likely to be highly resistant to disclosing precise details of their underlying holdings (possibly due to the restrictions in their own licensing agreements with benchmark providers or for their own commercial reasons) and, because ETF securities are traded on-market, superannuation funds would have no direct relationship with the ETF provider off which they could leverage for the purposes of negotiating access to the relevant data. The proposed legislation may create an impediment to superannuation funds investing in ETFs (i.e. because trustees may be unable to comply with their obligations if they do), which could frustrate the substantial efforts and expenditure by the ASX to foster growth in the Australian ETF market, which is still in its early stages.

#### ***Look through obligations***

- 2.10 The proposed regime seems to rely on a superannuation fund's custodian to notify third parties (i.e. with whom superannuation funds invest) to notify the third party that they are receiving superannuation fund assets and that there will be an obligation to disclose underlying holdings. The proposed drafting overlooks the prevalent use **of** sub-custodians and sub-sub-custodians and it is not clear that the provisions would be effective to impose obligations on sub-custodians and sub-sub-custodians, especially where they are situated in foreign jurisdictions. For

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example, National Australia Bank is one of the major providers of custodial services to Australian superannuation funds, and numerous funds have therefore entered into custody agreements with National Australia Bank. However, in practical terms, it is well known that a subsidiary (National Nominees Limited) acts as sub-custodian and performs the bulk of the custody services, with BNY Mellon acting as a sub-sub-custodian for offshore assets, in many cases with sub-sub-sub-custodians performing the day-to-day role in more exotic markets. Even though the obligation to publish underlying holdings would not apply to financial products acquired in other jurisdictions:

- (a) the obligation to notify third parties that they are receiving superannuation fund assets is not limited in that way and perhaps it should be, because otherwise the issue of sub-custodians acting under agreements governed by laws other than Australian laws would need to be addressed; and
  - (b) in any event, the treatment of locally based sub-custodians also needs to be addressed (perhaps by expanding the definition of ‘custodial arrangement’).
- 2.11 The Committee notes that there is nothing in the proposed section 1017BC which limits it to the superannuation context. Technically, it requires every custodian (even in a non-superannuation context) to notify third parties that they are receiving third party assets, even if this is not in fact the case.
- 2.12 There are inconsistencies (1) within the Explanatory Memorandum and (2) between the Explanatory Memorandum and the draft legislation. For example:
- (a) The Explanatory Memorandum suggests that the obligation to notify third parties that they are receiving third party assets (and the obligation to publish information about look-through holdings) ceases with the first entity which is unconnected with the trustee or its custodian (see paras 3.24 to 3.26 of the EM and the diagram in Example 3.1). However, this is inconsistent with later parts of the Explanatory Memorandum (e.g. para 3.66 and the diagram at Example 3.2) which show the disclosure obligation applying on the basis of a deeper look-through.
  - (b) In any event, the proposed new Corporations Act provisions (i.e. sections 1017BB and 1017BC) requiring notification of the fact that superannuation fund assets are being invested and, in turn, the disclosure of underlying holdings, has not been limited in the manner suggested by the Explanatory Memorandum. The concept of entities “connected with an RSE licensee” has only been reflected in the provisions which are to be inserted in the Financial Sector (Collection of Data) Act. In other words, the proposed Corporations Act provisions impose a broader obligation than that contemplated by the Financial Sector (Collection of Data) Act, whereas they should harmonise and be consistent.
  - (c) Similarly, the Committee notes that the Financial Sector (Collection of Data) Act does not include any relief regarding investments which are made in other jurisdictions, in contrast to the proposed section 1017BB(4).
- 2.13 In any event, further clarification is required as to when trustees are required to look through an investment vehicle for the purposes of disclosing underlying holdings and when they are not required to do so. For example, the provisions which are proposed to be included in the Financial Sector (Collection of Data) Act

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seem to focus solely on investments in managed investment schemes, pooled superannuation trusts and other trusts. However, this overlooks other structures, such as corporate vehicles (e.g. LICs / listed investment companies) and limited partnerships. In contrast, the proposed section 1017BB of the Corporations Act is not limited in any way, and requires disclosure of underlying holdings which are in any way derived from the assets of a superannuation fund. This would require disclosure on a look through basis where superannuation funds have invested in companies and limited partnerships. This being the case, it raises a question of when the look-through ceases. For example, if a superannuation fund were to invest in BHP Billiton shares (which they all do), the proposed section 1017BB would technically require superannuation funds to require the disclosure of all (listed and unlisted) invests held by BHP Billiton (and, in turn, all listed and unlisted investments held by those entities), which surely could not be the intention.

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## **Attachment A: Profile of the Law Council of Australia**

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The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its constituent bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Large Law Firm Group, which are known collectively as the Council's constituent bodies. The Law Council's constituent bodies are:

- Australian Capital Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Independent Bar
- The Large Law Firm Group (LLFG)
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of approximately 56,000 lawyers across Australia.

The Law Council is governed by a board of 17 Directors – one from each of the constituent bodies and six elected Executives. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive, led by the President who serves a 12 month term. The Council's six Executive are nominated and elected by the board of Directors. Members of the 2012 Executive are:

- Ms Catherine Gale, President
- Mr Joe Catanzariti, President-Elect
- Mr Michael Colbran QC, Treasurer
- Mr Duncan McConnel, Executive Member
- Ms Leanne Topfer, Executive Member
- Mr Stuart Westgarth, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.