Law Council
OF AUSTRALIA

Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017

Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017

Senate Standing Committee on Economics

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

Acknowledgement

The Law Council is grateful for the assistance of the Superannuation Law Committee (**the Committee**) of the Legal Practice Section in the preparation of this submission.

The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and clear. The Committee makes submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

Introduction

1. On 14 August 2017, the Committee made a submission to Treasury in response to the release of the exposure draft of the *Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017*. On 14 September 2017, the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017* (**IAMO Bill**) was introduced, in substantially the same terms, except with the addition of a schedule of amendments in relation to portfolio holdings disclosure.

2. On 24 July 2015, the Committee made a submission to Treasury in response to the release of the exposure draft of the *Superannuation Legislation Amendment (Governance) Bill 2015*.

3. The Bill lapsed, but on 14 September 2017 the *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017* (**STA Bill**) was introduced in similar terms to the earlier exposure draft Bill.

4. The IAMO Bill was referred to the Senate Standing Committee on Economics, together with the STA Bill.

5. The Committee attaches its 14 August 2017 submission on the IAMO Bill as all of the comments still stand, and provide a summary of the most important points below. In addition, we have made comments on the schedule of amendments in relation to portfolio holdings disclosure.

6. The Committee also provide a summary of the important points from our 24 July 2015 submission which remain relevant to the STA Bill.

PART 1 – Improving Accountability and Member Outcomes Bill

1. Annual *MySuper* outcomes assessment

Summary points:

- Apart from symbolic value, the proposed reforms are likely to lead to little substantive change in current practices since they largely involve attesting on an annual basis to having complied with existing regulatory obligations.
- The obligation in proposed section 29VN(3) to compare the fund's *MySuper* product with other *MySuper* products may be inherently problematic because funds operate in different sectors and for different types of members. At worst, this could incentivise trustees to breach their current duty to formulate investment strategies which are suitable for their membership and their fund's circumstances.
- If these reforms are to be pursued, the legislation should clarify whether the annual determination is intended to focus on retrospective performance or future prospects and, in any event, over what time period.
- As currently framed, a trustee who cannot make a confirmatory determination (i.e. that they are promoting financial interests) must effectively admit to a breach of the legislation and thereby expose themselves to statutory claims for compensation, and even class actions. This could discourage honest, frank and candid determinations being made. Consideration should be given

to designing a determination process which does not involve admitting to a breach of legislation if a confirmatory determination cannot be reached.

- If the annual *MySuper* outcomes assessment is introduced by the IAMO Bill and the Australian Prudential Regulatory Authority's (**APRA**) regular outcomes assessment is introduced by a Prudential Standard, Registrable Superannuation Entities (**RSE**) licensees will be subjected to two different yet overlapping assessment requirements (see further below).

7. In addition, the Committee is very concerned by the proposal to replace the existing annual *MySuper* scale assessment with the annual *MySuper* outcomes assessment contained in the IAMO Bill at the same time as APRA proposes to consult on a requirement for all RSE licensees to 'regularly assess' whether they are providing 'quality, value for money outcomes for beneficiaries in all of its RSEs and products' (see APRA's letter to all RSE licensees dated 11 August 2017).

8. If the annual *MySuper* outcomes assessment is introduced by the IAMO Bill and APRA's regular outcomes assessment is introduced by a Prudential Standard, RSE licensees will be subjected to two different yet overlapping assessment requirements. APRA has confirmed to the Committee that its proposed regular outcomes assessment would cover both *MySuper* products and Choice products. The duplication that would occur in relation to *MySuper* products is obvious – and yet each requirement would require the trustee to conduct a somewhat different assessment. Under the annual *MySuper* outcomes assessment, the trustee would need to carry out the assessment against the criteria set out in the IAMO Bill. Under APRA's regular outcomes assessment, the trustee would need to carry out the assessment having regard to 'net investment returns, expenses and costs, insurance, and other benefits and services provided'.

9. If both measures are introduced, the Committee considers the result will be overlapping, poor quality law where the requirements imposed on trustees are unclear and uncertain. The Committee has raised this concern directly with APRA. However, if the Senate Committee shares our concern, we would recommend the Senate Committee to make this known in its report on the IAMO Bill.

2. Authority to offer a *MySuper* product

Summary points:

- Is there a need for the change to enhance APRA's powers in these sections?
- The proposals – perhaps inadvertently – make it easier to obtain *MySuper* authorisation.

10. The Committee notes that the proposed amendments to sections 29T and 29U are relatively minor in terms of drafting changes to the existing text of those provisions, but these changes appear to alter the ease with which *MySuper* authorisations can be obtained – possibly in ways which were unintended.

11. Also, the Committee queries the rationale for the proposed amendments to section 29U(2). APRA already has a broad power to cancel a *MySuper* authorisation under section 29U(1). Section 29U(2) expressly states that nothing in it limits the power in section 29U(1). There is no need for the amendment.

3. Director penalties

Summary points:

- These changes expose superannuation trustee directors to more risk of personal liability than any other directors in Australia. In our view, this aspect of the reforms should not proceed.
- If the Government does want to impose pecuniary penalties for breach of the SIS director covenants, the Committee considers that it should align all aspects of the SIS liability regime with the managed investment scheme regime by removing the direct liability to members that superannuation directors currently have.

12. The Committee is disappointed that none of our comments on the exposure draft were taken into account.

13. The rationale for these penalties is said to be an alignment with the penalties imposed on directors of registered managed investment schemes under Chapter 5C of the *Corporations Act 2001* (Cth) (**Corporations Act**). However, as explained in the Committee's previous submission on the exposure draft, this rationale completely overlooks that directors of managed investment schemes are not exposed to being sued by members for loss in the way that directors of superannuation trustees are.

14. If the IAMO Bill is passed in this form:

    - Directors of superannuation trustees will be exposed to a higher degree of liability than any other directors in Australia. They will be exposed to civil penalties if the regulator prosecutes them under the new penalty regime and they will also be exposed to being sued directly for loss by the members of the superannuation fund (as at present). We can see no empirical or policy basis for this position.
    - This high degree of exposure will be an obstacle to procuring independent professional directors on superannuation trustee boards and therefore operates contrary to the STA Bill.

15. We have suggested that a true alignment with managed investment scheme directors would be achieved if, at the same as imposing the superannuation director penalties under proposed section 55AA, the Government were to 'carve out' the director covenants from section 55 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**).

4. Approval to own or control an RSE licensee

Summary points:

- The notification requirement should be subject to a materiality and knowledge threshold.
- The pro forma additional RSE licence conditions published by APRA concerning change of control will need to be removed.
- Division 2 of Part 16A should be drafted more clearly to use the concepts of 'controlling stake' and/or 'practical control'.

5. APRA directions power

Summary points:

- The proposed new power to be given to APRA is far-reaching. So as to limit the risks inherent in such a power, APRA should, in most cases, be required to afford trustees with a reasonable opportunity to respond and submit argument prior to the formal direction being applied.
- A new provision should be added to require APRA to form the view that, if it were to consult with the trustee on the proposed direction prior to it being issued, the trustee would be unlikely of its own volition to act in the manner proposed in the direction.
- APRA already has direction powers under the SIS Act which are still significant and arguably sufficient for its purpose.
- It is unclear whether APRA has power under proposed section 131FA to direct a trustee to act contrary to the terms of its trust or governing rules.
- Nevertheless, if these reforms are to be implemented, we strongly endorse the foresight in providing statutory safe harbours for trustees which comply with any directions which may be given. These protections are essential.
- However, even though a trustee cannot be sued for complying with an APRA direction, this does not mean that the trustee is entitled to recover the costs of complying with the direction from the fund assets if the relevant course of action would otherwise have been beyond the trustee's powers and/or outside the scope of the trustee's indemnity under the trust deed. A statutory right of indemnity should be created to ensure that this is the case.

6. Portfolio holdings disclosure

Summary points:

- This measure will impose a significant compliance burden. More targeted disclosure of, say, the top 100 shareholdings or those representing more than 1% of the portfolio would be significantly more appropriate from a number of perspectives. There is scope for regulations to specify a materiality threshold and also to allow particular categories of investment to be clustered and disclosed in aggregate.
- The proposal to allow funds to withhold disclosure of up to 5% of an option's assets on grounds of commercial sensitivity goes some way to alleviating industry's concerns about commercial sensitivity, but not far enough.
- There should be a special carve out for superannuation products which track a market index (because it will almost always be a breach of the licence pursuant to which the superannuation fund has access to market index data if the superannuation fund were to disclose the portfolio's holdings).
- In light of the proposal to excuse superannuation funds from the obligation to disclose the securities which are held by a non-associated entity in which they have invested, we query whether sections 1017BC, 1017BD and 1017BE of the Corporations Act can now be repealed.

16. The Committee has provided detailed comments on portfolio holdings disclosure proposals on numerous occasions in the past. Our advice has consistently been that those proposals are contentious for industry and represent a significant compliance burden which would predominantly be suffered in the course of producing voluminous disclosure, most of which would be of little use, meaningless and immaterial to typical members of superannuation funds. Given that some superannuation products would have exposures to thousands of global securities, the vast majority of which would represent miniscule percentages of the portfolio (at the second decimal point), we have instead suggested that more targeted disclosure of, say, the top 100 shareholdings or those representing more than 1% of the portfolio would be more manageable, more useful for members and pose less problems from industry's point of view. While these suggestions have not been taken on board, we nevertheless observe that several of the proposed revisions are, at the margins, helpful and likely to be received positively by industry, compared to the alternative.

17. Under the proposals, there is scope for regulations to specify a materiality threshold. Hopefully that power will in fact be exercised to specify a materiality threshold that enables significant compliance costs to be avoided in place of voluminous disclosure of limited utility. In the past, there had been some suggestion that this power was unlikely to be exercised in practice.

18. Similarly, the proposals contemplate regulations which will allow particular categories of investment to be clustered and disclosed in aggregate. Again, hopefully this power will in fact be executed. Some asset classes would benefit from clustered disclosure more than others – for example, bonds and term deposits (to avoid a multiplicity of bonds and term deposits (with different maturities or different interest rates) issued by the same issuer being disclosed as separate line items), cash accounts (to avoid a multiplicity of accounts issued by the same bank being disclosed as separate line items) and derivatives. In the case of derivatives, clarity is still required as to whether trustees should disclose the counterparty with whom the derivative exposure is held, or the asset to which it relates. For example, should a derivative trade with, say, Commonwealth Bank with respect to shares in Westpac be disclosed as an exposure to Commonwealth Bank or to Westpac? The returns to members depend on Westpac share performance, but the counterparty exposure is to Commonwealth Bank.

19. The abolition of look-through disclosure *vis-a-vis* non-associated entities will be received positively by industry.

20. The proposal to allow funds to withhold disclosure of up to five per cent of an option's assets on grounds of commercial sensitivity goes some way to alleviating industry's concerns about commercial sensitivity, but not far enough. The concern here has always been that other market participants would use information concerning a superannuation fund's book value of an unlisted asset to their own advantage – for example, if a third party wished to purchase an asset from a superannuation fund, they would know what book value they had to meet; equally, if a third party wanted to sell a stake in an unlisted asset to their superannuation fund co-investor, they would know how much the superannuation fund may be willing to pay, based on how the superannuation fund had valued their existing stake. The problem with the five per cent limit is that many superannuation funds would have more than five per cent of their portfolio invested in unlisted assets and, since they will have no way of knowing what asset may be transacted next, there will always be a risk that the next transaction involves an asset that they did not choose to include in the five per cent

for which disclosure was withheld, which would be to the disadvantage of the superannuation fund.

21. Further, there needs to be a special carve out for superannuation products which track a market index. Since the introduction of *MySuper* products, and the enhanced focus on lowering costs, there is likely to be an increasing number of superannuation products which track a market index (since these are the cheapest products to offer). The problem here is that it will almost always be a breach of the licence pursuant to which the superannuation fund has access to market index data if the superannuation fund were to disclose the portfolio's holdings. This is because disclosing the portfolio's holdings (even on a lagged basis) involves disclosing the constituents of the market index at a particular moment in time, which is the intellectual property of the index provider and almost always a breach of licence to disclose. These agreements are often governed by foreign laws (for example, New York law) and therefore enabling provisions in the Corporations Act are of little utility. It is not reasonable to compel a superannuation fund to commit a breach of licence and to expose the fund (and its members) to an action for damages. This is a special case which warrants a special carve out.

22. In light of the proposal to excuse superannuation funds from the obligation to disclose the securities which are held by a non-associated entity in which they have invested, the Committee queries whether sections 1017BC, 1017BD and 1017BE of the Corporations Act can now be repealed. Those provisions seem to have been designed to facilitate superannuation funds obtaining information from non-associated entities, which would no longer be necessary under these reforms.

7. Annual members' meeting

Summary points:

- The Committee is uncertain about the need for or benefits arising from a requirement to hold annual member meetings because superannuation fund members already have very clear existing rights to make enquiries and request information.
- In contrast to an annual general meeting of shareholders in a company where business is transacted and resolutions are voted upon, an annual meeting of members would effectively be a mandatory attempt to engage with members on an annual basis.
- Since there would be no resolutions to be voted upon, there would be no need for all members to attend or be present at the same meeting at the same time. Flexibility should be allowed so that trustees can choose to conduct multiple annual meetings (for example, in different States and territories) on different days in order to facilitate attendance by a greater number of members in person. For similar reasons, greater flexibility should be allowed in terms of which responsible persons are in attendance at meetings.
- Similarly, where a trustee acts as trustee of multiple funds, they should be permitted to conduct the annual meeting for all of those funds simultaneously.
- If member meetings were to be required:

- tensions may arise between the trustee's duty to manage and administer the fund and members seeking to direct how the board of the trustee fulfils that duty;
- the grounds on which a trustee can decline to answer a question should be expanded – for example, where there is insufficient time, where questions are repetitive, vexatious, offensive or designed to ridicule or concern confidential or privileged matters (rather than relying on the exemption for questions which pose a detriment to members) or relate to persons other than the member asking the question;
- there is no clear provision for how individual member issues raised might be addressed at such meetings;
- the definition of "member" should be made certain for the purposes of proposed section 29P;
- the exceptions to proposed section 29PB need further clarity; and
- the new provisions do not establish fundamental matters about how a meeting of members of a superannuation fund might be properly held.

8. Reporting standards

Summary points:

- The reference to "another entity" in proposed section 13(4D) should be clarified as to whether it is intended to be a reference only to an entity which is a "financial sector entity" covered by the Act, or any entity more broadly.
- Proposed section 13(4D) would capture an extremely broad range of transactions, and require disclosure of information which at present may be considered commercially confidential.
- Compliance costs will be difficult to justify by reference to the stated regulatory outcomes which are sought to be achieved by the new reporting standards.

PART 2 – STA Bill

23. If the STA Bill is passed, it will remove the equal representation rules from the SIS Act. It will require one-third of the directors (including the chair) of a Registrable Superannuation Entity licensee (**RSE licensee**) to be 'independent of the RSE licensee'.

24. The same requirements will apply where the RSE licensee is a group of individual trustees. Directors of a corporate RSE licensee are considered below. The Committee's comments apply equally to an RSE licensee that is a group of individual trustees.

Composition of the board

25. If the STA Bill is passed, the Act will no longer require the board of a trustee of a standard-employer sponsored fund to include any employer or member representative directors. This will create the possibility of two-thirds of a trustee board being comprised solely of, for example, employer representative directors or employee representative directors. The Committee questions whether this is the

intention of the Government and, if not, whether the STA Bill should merely add the requirement for one-third of a board's directors to be independent of the existing equal representation rules.

26. The STA Bill will also remove the requirement for trustees of public offer funds to establish policy committees for employer plans and attend a meeting of the policy committee at least annually. While policy committees have a limited role, they do provide an opportunity for members and employer-sponsors of public offer funds to provide their views to the trustee and for the trustee to meet with representatives of the members. The Committee queries whether there is merit in retaining the requirement for policy committees despite the equal representation rules being removed.

Independence

27. In order to work out whether a director (or a candidate to be a director) is independent of an RSE licensee, the RSE licensee will need to consider the new definition in section 87 of the Act.

28. While Part 9 is intended to bring directors, who are able to exercise independent judgement to their role onto boards, the Part does not in fact require the RSE licensee to ask this question. The Committee queries whether the RSE, like APRA when it exercises its new powers under section 88 and 90, should be required, first, to ask whether the person is likely to be able to bring independent judgement to the role. In doing so, the legislation could require the RSE licensee to have regard to their associations and relationships.

29. Section 87(1)(f) does not work well in relation to fund trustees who are also employer-sponsors of the fund (i.e., where the trustee employs more than 500 staff, which staff are also members of the fund). In this case, the employer is a 'large employer' within the meaning of section 29TB, and a director of the trustee will not be considered to be independent simply because the trustee employs 500-plus people who may be members of the fund. In effect, this will coerce large trustee organisations to outsource their functions. This will be a particular issue for large funds which are self-administered. The Committee queries whether this indirect pressure to outsource is an intended outcome of the trustee governance reforms.

30. Equally, if those employees happen to be employed by a service company that is wholly owned by the superannuation fund, and if the trustee directors are on the board of that service company, a director should not lose their independence merely because of that fact – regardless of how many employees there are.

31. With regard to the general rule that an independent director should not have an association with a large sponsoring employer (other than the trustee itself, in our submission), the Committee believes that it should be clarified whether the 500 employee rule applies to current employees or whether former employees who are still members of the fund are also to be counted.

32. There is an additional point to make regarding the proposed rule that persons who are directors or officers of service providers (or entities in a business relationship with the trustee) cannot be independent. This general rule is logical in cases where payments to that entity represent a leakage from the fund's assets, since the director would have a conflict of interest and/or duty in terms of promoting the financial interests of members, on the one hand, and maximising returns to the service provider's shareholders, on the other hand. That mischief does not exist in cases where the service provider entity that the trustee has a business relationship with is

itself owned by the superannuation fund. Those cases are essentially a mutual-like arrangement, since the shareholder of the service provider is the superannuation fund itself (represented by the trustee). Any amounts paid to the service provider ultimately benefit the members of the superannuation fund, meaning there is no conflict. In our view, there is no need for a trustee director who is also a director or officer of the service provider to lose their independent status in this particular situation. Note that the usual position (as drafted) would be entirely logical in cases where the service provider is owned by the entity which is the trustee but critically, not in its capacity as trustee on behalf of the fund.

33. The Committee is aware of at least one large superannuation fund which is generally recognised as already having independent directors who would, anomalously, in the Committee's view, find that those independent directors are no longer regarded as being independent, unless these anomalies are addressed.

34. The Committee suggests that a director should be deemed, for the purposes of the Act, to be independent of the RSE licensee, if the RSE licensee is satisfied that the director does not have any relevant/material associations or relationships that would prevent the director exercising independent judgement in performing the role of director. In exercising its power to determine that a particular person is or is not independent of the RSE licensee under the new section 88 of the Act, APRA will be required to determine whether it 'reasonably believes' that the person is likely or unlikely to be able to exercise independent judgement. The Committee thinks that it would be appropriate for the RSE licensee to be able to determine whether a particular candidate or director is independent of the RSE licensee having regard to the same assessment. Given APRA's powers to determine that a person is not independent, it is difficult to see that there would be any mischief if this approach was also available to the RSE licensee. Moreover, this test appears to go to the heart of what it means to be 'independent' – the person's associations or relationships with the RSE licensee and its associates are merely examples of where they may not have the necessary independence.

Protection from breach

35. The STA Bill includes a new section 94 which will provide that a person will not breach any provision of 'a trust deed or other rules according to which a registrable superannuation entity is administered' by complying with Part 9. The Committee also notes that the SIS Act includes a definition in section 10 of 'governing rules' of a fund that includes the trust instrument and other rules governing the establishment or operation of the fund. The Committee recommends that that term be used in the section. (The same comment applies to the wording section 25 in "Part 3 - Application and transitional provision".)

Further comments on the independence test in section 87:

Shareholding

36. The shareholding provision will create unnecessary difficulties for trustee companies that have constitutions that require all directors to hold shares in the company.

Wholly owned service providers

37. Proposed section 87 precludes a person from being classified as an independent director if, in the preceding 3 years, they have been an officer or director of an entity which has had a material business relationship with the RSE Licensee in the

preceding 3 years. For example, if a person had recently held a board position with a service provider, they would not constitute an independent director.

38. The Committee questions whether there should be an exception where the service provider (or the body corporate which has the material relationship with the RSE licensee) is wholly-owned by the RSE Licensee as a fund asset – in other words, where the fund and the service provider essentially operate as a ‘mutual’ arrangement. If an RSE Licensee wholly owns the service provider, the Committee queries whether the intention is to preclude the same persons serving as directors on both boards. As drafted, the proposed provisions would preclude a person from being treated as an independent director of the RSE Licensee if they also serve as a director on the board of a wholly owned service provider. Such a situation would not necessarily give rise to any conflict of duty, since the directors on the board of a solvent wholly-owned entity would be duty bound to act in the best interests of their sole shareholder, that being the RSE licensee in its capacity as trustee of the fund. In other words, the directors of a solvent wholly owned entity would have a duty to act in the best interests of the members of the fund which would be co-extensive with their duties as directors of the RSE licensee.

Nominating organisations

39. Section 87(1)(f) does not actually achieve independence from nominating organisations because the nominating organisation could simply nominate someone who is not a director or executive officer of the organisation and that person would be considered independent.

Wholly owned investment vehicles

40. Similarly, the Committee queries whether there should be an exception for cases where an RSE Licensee establishes a wholly owned entity to act as a holding vehicle for its investments. Technically, there would be a material (investment) relationship between the RSE Licensee and its holding vehicle. As such, any person who serves as a director on the board of the holding vehicle would be precluded from being treated as an independent director on the board of the RSE Licensee. We query whether such a prohibition is necessary.

3-year look back

41. The proposed drafting precludes a person from being an independent director if, in the previous 3 years, they have served as an officer or director of a body corporate that has had a material relationship with the RSE Licensee in the previous 3 years.

42. In some cases, the rationale for the 3-year look back is self-evident - for example, where an audit partner responsible for auditing an RSE Licensee leaves their audit firm and seeks appointment as a director of the RSE Licensee. However, if the material relationship between an RSE Licensee and a body corporate has been terminated, the Committee queries why an officer or director of that body corporate should in all cases be precluded from being treated as an independent director. For example, if an RSE Licensee has previously terminated the appointment of a particular investment manager or custodian, is there any reason why an officer of that service provider should be precluded from being classified as an independent director? Such a person would be unlikely to have any allegiance to the new incumbent service provider and indeed could well bring a helpful perspective to bear when monitoring the new incumbent service provider.

43. The Committee also questions whether the drafting should distinguish cases where the person was not an executive officer or director of the other company at any time while it was a service provider to the RSE Licensee. For example, if a person was a director of a body corporate until the end of 2014, and then retired, and then the body corporate was later appointed by the RSE licensee in 2015 to provide services, is there any reason why that person should be precluded from being treated as an independent director in all cases?

Contact

44. The Committee would welcome the opportunity to discuss the submission further. Please contact John Farrell, Policy Lawyer, at john.farrell@lawcouncil.asn.au or (02) 6246 3714, if you would like further information or clarification in the first instance.