Australian Government

REVIEW INTO THE GOVERNANCE, EFFICIENCY, STRUCTURE AND OPERATION OF
AUSTRALIA'S SUPERANNUATION SYSTEM

CLEARER SUPER CHOICES:
MATCHING GOVERNANCE SOLUTIONS

Phase One – Preliminary Report
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1. INTRODUCTION

On 29 May 2009, the Government announced a comprehensive review of Australia's superannuation system: the Super System Review (**Review**).

The Review has broad terms of reference.[1] It has been charged with examining and analysing the governance, efficiency, structure and operation of Australia's superannuation system. The Review is focused on achieving an outcome that is in the best interests of members and which maximises retirement incomes for Australians.

On 25 August 2009, the Review Panel released an Issues Paper titled, '*Phase One: Governance*', calling for submissions by 16 October 2009 on a range of issues relating to the governance of superannuation funds regulated by the Australian Prudential Regulation Authority (**APRA**).

This paper, the Review Panel's initial 'Preliminary Report', is an opportunity for the Panel to start to outline the key themes that are emerging in its work so far. It is informed by analysis of the submissions on the Phase One Issues Paper, stakeholder discussions and by the research undertaken by the Panel in preparing the two subsequent Issues Papers (including a recent international study tour). This Preliminary Report is intended to communicate the Panel's current direction as a means of focusing community discussion and providing early feedback on the trends, issues and ideas under consideration.

This Preliminary Report contains few finalised recommendations. One submission and several stakeholder discussions suggested that the Panel not make recommendations on governance until after consultation on Phases Two and Three are complete because conclusions reached in those Phases could have a bearing on governance.[2] The Panel accepts the logic of that position. The Panel expects that its final views and recommendations on governance will be strongly informed by the Panel's examination of Phases Two and Three of the Review: Operation and Efficiency, and Structure (including SMSFs). After taking into account submissions and deliberations during Phases Two and Three, the Panel's conclusions on governance will form part of its final report due by 30 June 2010.

To this end, stakeholders are invited to make comments about this Preliminary Report by way of a submission in Part Three: Structure (including SMSFs).

There are, however, a few issues that were raised in the *Phase One: Governance* Issues Paper which the Panel believes it can now say are not going to be pursued in the Review, either because there is a strong consensus on the issue or because it has limited dependence on the broader discussions still taking place. These issues are addressed briefly in section 7 of this document.

1 http://www.supersystemreview.gov.au/content/terms_of_reference.aspx.
2 IFSA submission page 10.

2. SUMMARY OF EMERGING THEMES

The Review received over 110 formal submissions in *Phase One: Governance*. In addition, the Review has conducted over 100 meetings with industry associations, superannuation funds, financial institutions, academics, lawyers and other interested parties, both in Australia and overseas. Some key themes have emerged.

The first is that superannuation is not just another 'financial product'; it is different. As the superannuation system has an overarching social policy objective, funds management and financial products are tools facilitating that purpose, rather than an end in themselves. This has implications for the types and intensity of regulation required for the superannuation system. It supports the view that super should have special rules in some areas. In a mandatory system, the government has an added responsibility to get the settings right. It also adds weight to the need for protection of member interests. This is especially true in situations where the individual member is not equipped, either because of circumstances or through lack of financial literacy, to secure their own best interests.

The second is that though competition is an important ingredient in any dynamic industry, the experience in the superannuation industry (and in comparable overseas systems) suggests strongly that competition has not and cannot achieve all the objectives expected of it. The Panel's preliminary research suggests that while parts of Australia's superannuation industry are highly competitive and close to (or at) global best practice, competition has failed to deliver best practice in other parts of the industry. It is important to find a balance between allowing market forces to deliver competitive and innovative outcomes in areas where that works, and using regulatory shaping where markets have been less effective. This is not to signal, however, that the Panel has a general appetite for increased regulation.

The third is that governance is necessarily linked to operational and structural issues. The optimal governance structure will depend on the context in which the entity operates. This means that there are very few 'one-size-fits-all' solutions to superannuation fund governance. There must be room for different models and for flexibility to accommodate change and innovation.

The fourth is that Australia's retirement incomes system places far greater weight on the second 'pillar' (compulsory occupational superannuation) than is the case in other comparable Organisation for Economic Co-operation and Development countries. Also, Australia's system is more oriented towards defined contribution funds and offers greater choice than most other comparable systems. Thus, overall, individual members bear directly more of the investment and other risks inherent in financial markets in providing for their retirement than is the case overseas. The combination of these factors makes the safety and efficiency of the superannuation system of greater importance to individual members than in other countries.

Lastly, Australia's superannuation system has grown tremendously in size and importance over the past 17 years. On most grounds, it can be regarded as having been a success. In particular, the system has demonstrated substantial resilience in one of the most severe financial market crises of the past century. Not surprisingly, many industry participants have expressed a view, that since the system 'ain't broke', there is no reason to 'fix it'. The Panel questions this view and believes that the review process is an opportunity to position the superannuation system for the challenges of the next 15 years and beyond.

3. STATEMENT OF PRINCIPLES

The government has articulated four principles that will guide its assessment of the recommendations in this Review.[3] They are:

- **simplicity**;
- **efficiency**;
- **equity**; and
- **adequacy**.

The discussion below respects these principles, recognising that the fourth, adequacy, is outside the scope of this Review.

4. THE SUPERANNUATION SYSTEM IN 2025

Australia's superannuation system is expected to continue to grow strongly over the coming 15 years, underpinned by mandatory contributions and by demographic factors.[4] This Review provides a valuable opportunity to take stock of the current system in light of how it might develop and to make recommendations designed to enhance its simplicity, efficiency and equity.

Just as in 1993, when the current architecture of the system was established, it is hard to envisage exactly the course those changes will take. In 1993, total superannuation assets amounted to $183 billion,[5] and the industry was dominated by corporate funds and by large, partly-funded public sector schemes. The self-managed superannuation fund (**SMSF**) sector, as we know it today, did not exist.

What might the superannuation system look like in 15 years time? And what implications might that have?

Forecasting the size and structure of the superannuation system over the coming 15 years is not an easy task, given the system's dynamism and complexity. The table below, drawn from analysis conducted by Treasury, starts to set the scene.

3 The Hon Chris Bowen MP, Address to ASFA 2009 Conference Closing Address: The New Age of Super http://mfsscl.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2009/009.htm&pageID=005&min=ceba&Year=&DocType=1.

4 Se G Rothman and D Tellis, *Projecting the Distributions of Superannuation Flows and Assets*, 16th Colloquium of Superannuation Researchers, University of New South Wales, 3-4 July 2008, Conference Paper 08/1.

5 APRA Superannuation Trends June Quarter 2001.

Table 1: The Australian superannuation industry in 2025[6]

	1996	June 2009	2025 (nominal $)[7]	2025 (current $)
Overall industry scale	$245 billion	$1.1 trillion	$3.2 trillion	$2.2 trillion
Ratio of accumulation to post-retirement assets	-	4:1	3:1	3:1
Biggest fund	-	$41.5 billion	$185 billion	$126 billion
Number of funds (excluding ERFs)	4734	447	119	119
Average fund size	$40 million	$1.5 billion	$17.2 billion	$11.7 billion
Average accumulation member account balance	$15,000	$70,000	$164,000	$105,000
Total super assets - proportion of GDP	47%	90%	120%	120%
Total super assets - proportion of ASX[8]	71%	102%	73%	73%

Of course, the estimates above are just that, estimates and are subject to a number of assumptions. They do, however, highlight a number of important points:

- The average fund size will be much larger, even in real (current dollar) terms. This, in turn, will have implications for fund governance, for investment and prudential regulation.
- The largest funds will be very large by current standards, though even these will remain small by global standards.
- Member account balances will be materially larger than at any time in the history of superannuation. This will put pressure on member remediation processes across the system and will further intensify issues around identity theft and fraud and trustee accountability to members.
- The superannuation system will continue to be an important factor in the Australian economy and financial markets. The efficiency of the sector will have macro-economic effects.
- Local funds will find themselves competing with large global funds, not just in markets for listed securities, but also in respect of specific assets, such as infrastructure, private equity and direct property.

6 See appendix 1 for the assumptions.
7 Basis for forecasts can be found in the key assumptions underpinning the 15-year scenario in appendix 1.
8 Projected financial year average market capitalisation of domestic listed equities.

5. AN ENHANCED ARCHITECTURE FOR SUPER

The regulatory infrastructure supporting the superannuation industry distinguishes between different types of fund to some extent. At the margin, there are different rules applied to 'public offer' funds, to defined benefit plans and to SMSFs. For the most part, though, the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**) assumes that there should be a single model of superannuation fund governance.

The Panel believes that industry developments since the enactment of the SIS Act make this approach inadequate. More importantly, although the one-size-fits-all approach appears equitable, in practice it results in the illusion of protection or the primacy of member interests in certain situations and in unnecessary complexity and cost in others.

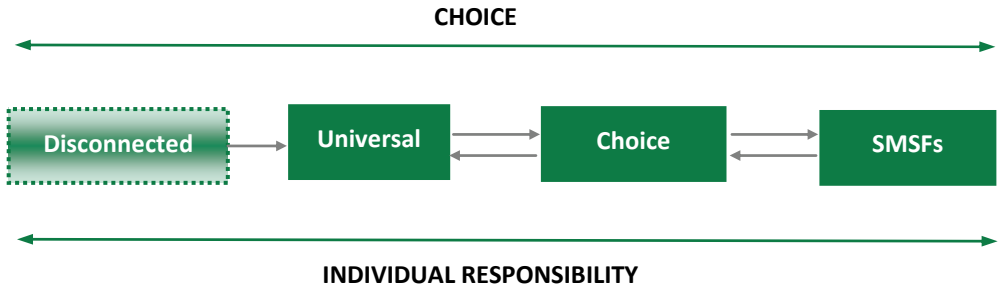
The Panel believes that there has to be room in a system where there are compulsory contributions for a governance model that addresses not only the disengaged member, but also the member who exercises choice about the fund (or investment option) to which they belong. There also needs to be more clarity for members about the differences between the various models and what those differences mean regarding the trustee's duties to the member.

5.1 A choice architecture model for superannuation

The diagram below suggests an alternative approach. It starts from a member, rather than a product or industry sector, perspective. It classifies members on the basis of whether or not they have made a choice about their superannuation. It recognises that direct engagement in superannuation decision-making is not currently a priority for a large portion of the population. However, it also recognises the value of choice to some individuals and to the superannuation system as a whole. Regard is also had to the practical reality, hopefully declining, that some individuals and some or all of their superannuation are currently temporarily 'disconnected.'

For purposes of this Report, we describe the model portrayed in Diagram 1 below as a 'choice architecture' model.[9]

Diagram 1: A choice architecture model for Australia's superannuation system



5.1.1 A brief description of the choice architecture model

The model classifies members into three main types: universal, choice and self-managed. Those who did not make an express choice would be placed in the universal category. If a

9 Thaler, R and Sunstein, C 2008, *Nudge - Improving decisions about health, wealth and happiness,* Yale University Press.

member loses connection with their account, that account will be transferred to the disconnected category. People could conceivably have interests in more than one category, though this would be by choice, and not by poor record-keeping or because they are unable to consolidate multiple superannuation accounts.[10]

It is not intended that only not-for-profit entities should be able to participate in the universal category, nor that only retail financial institutions should be able to participate in the choice category. All organisations would, however, have to comply with the rules and regulations that related to that particular category. Also, the Panel thinks it is desirable that there be very clear distinctions between the universal and the choice categories; a distinction that is currently blurred.

Some of the design features envisaged for each category of member are summarised in the table below and include:

- **Disconnected member:** Must be placed in a fund with the following features: low cost, conservative investment strategy, minimal information or disclosure, low cost facility to aid member identification so as to expedite relocation, consolidation, and transfer to other categories.
- **Universal member:** Must be in a fund with a single diversified investment strategy (including a life-cycle strategy) overseen by trustee with traditional duties, insurance offered, but few other 'bells and whistles'. Limited role for advice because advice is 'embedded' in the product and no choices need to be made by the member.
- **Choice member:** Will be in a fund with potentially unlimited menu of options for investment, insurance etc, though still subject to sole purpose test, trustee responsible for reasonable due diligence on investment and insurance options offered, but limited liability for choices made by individual members, effective disclosure of paramount importance. Members likely to rely on advice or disclosure and other information about their options.
- **Self-managed:** Because SMSFs are being dealt with in Phase Three: Structure, it is too early to suggest possible changes to the SMSF sector.

10 Measures to address the fragmentation of an individual's superannuation holdings are being considered formally in Phase Two of this Review.

Diagram 2: Key features of fund models under choice architecture

	Disconnected	Universal	Choice	Self-Managed
Investment strategy	Conservative	Single strategy (incl. lifecycle)	Supermarket	Self-directed
Governance philosophy	Trustee-centric	Trustee-centric	Disclosure-based	Self
Ability to change option/fund	N/A	Less frequent	More frequent	N/A
Insurance	N/A	Death & TPD	Member decision	N/A
Reporting	-	Minimal	Comprehensive	Compliance based
Product Disclosure Statement	-	Streamlined perhaps on-line only	Comprehensive	N/A

5.1.2 Implications of the choice architecture model

First, it orients attention towards members and away from 'products' and industry sectors.

Second, the model uses the conscious choices of individuals to calibrate the levels of governance, regulation and member protection applicable.

- 'Disconnected' members will receive the highest protection.
- 'Universal' members will receive the protection afforded by the duties imposed on a traditional trustee who is a fiduciary acting single-mindedly in the best financial interests of members.[11]
- 'Choice' members will bear substantial responsibility for the investment choices or fund choices that they make.
- 'Self-managed' members will, subject to conformity with certain minimum standards, be self-reliant.

Apart from the moral authority derived from using an individual's own choices (or lack of them) to calibrate the protection they receive, this approach removes the ambiguity currently present in the market around such issues as a trustee's responsibility for the investment choices made by members. [12]

11 The gradation of 'fiduciary' responsibility currently accommodated under the trust model is discussed further below.

12 See for instance Donald, M S 2008, '*The prudent eunuch: Superannuation trusteeship and member investment choice*', 19 Journal of Business and Finance Law and Practice 5.

Third, the diagram above highlights that different governance (and regulatory) models will be appropriate for the different types of members. Prudential regulation is more relevant to the 'universal' and 'choice' segments than the 'self-managed' sector, for instance. Likewise, a traditional trustee role is more relevant to the 'universal' sector than the 'choice' sector.

Fourth, the model facilitates more precise allocation of costs to members. The costs of the compendious disclosure documents, advertising and transactional infrastructure required to facilitate member investment choices will be borne directly by those in the choice sector. The Panel recognises that applicable accounting standards might need to be enhanced to ensure that all expenses relevant to a particular investment option within a fund are required to be captured on a full absorption basis so that no cross-subsidies can occur.

Fifth, the model accommodates movement between the segments, albeit with some regulation. The potential for moral hazard and the removal of layers of protection means that movement towards segments offering increasing choice (that is to the right) cannot be allowed to be inadvertent. Participants moving in that direction must signal their intention expressly and unambiguously. One preliminary idea here is the imposition of 'suitability gates' similar to those employed in the United Kingdom by the Financial Services Authority (**FSA**). Specifically, these require that an adviser ensure that:

- the product recommended to a client meets the client's investment objectives;
- the client can bear the risks involved in the product;
- the client has the wherewithal to understand the nature of the risks involved;
- the client's demands and needs are explicitly identified;
- there is a clear explanation as to why this product specifically is suitable for this client; and
- any potential disadvantages are clearly explained.[13]

On the other hand, it does not seem that any restriction needs to be placed on member movement in the other direction (for example, a move from self-managed to universal).

Lastly, one segment of the industry is not captured in this model: defined benefit plans. These plans remain an important, but declining, part of the industry. More importantly, the allocation of investment and other risks in defined benefit plans are quite different from those in accumulation plans, which have implications for the governance and administration challenges they face. The Review believes these plans should be subject to a regulatory environment tailored to their unique requirements. Defined benefit plans are specifically covered in the *Phase Three: Structure (including SMSFs)* Issues Paper.

This model does not represent a complete break from the current structure of the industry by any means. The 'disconnected' and 'self-managed' sectors exist today in the form of eligible rollover funds (**ERFs**) and SMSFs. Similarly, there are today both universal and choice

13 For further information see http://fsahandbook.info/FSA/html/handbook/COBS/9. Additional provisions specific to pensions can be found at http://fsahandbook.info/FSA/html/handbook/COBS/19.

products available in the market; they might have different names and details, but they are essentially recognisable.

The major difference in the choice architecture model is the clearer distinction made between the 'universal' and 'choice' sectors. Market developments over the past decade have seen not-for-profit funds offer greater choice so that they have come to look more like 'commercial' entities, while platforms and other retail products have been positioned to receive contributions directly from employers in satisfaction of employer obligations under the *Superannuation Guarantee (Administration) Act 1992* (**SG Act**).

In the model outlined above, organisations would be able to offer either (or both) universal and choice products to members, but the requirements pertinent to each of the types of product would need to be met. A number of submissions indicated a desire to see differentiation along these lines.[14]

The Panel's current thinking is that only a fund with the characteristics of the 'universal' model should be capable of becoming a 'default fund' for the purposes of the Commonwealth industrial award system and the SG Act.

5.1.3 Summary of key intended outcomes

- Clearer choices/boundaries – based on existing market sectors.
- The 'universal' product is simpler and cheaper for members.
- Members can choose (and pay for) a more tailored solution that suits them.
- Overall, the system is more accountable to members.

6. PRELIMINARY RESPONSE TO SELECTED GOVERNANCE ISSUES

6.1 Listed company standard of governance

The Panel is attracted to the general proposition that governance of APRA-regulated super funds should be equivalent to the standard applying to a listed company. There will be instances where the standard observed by funds is already higher than that required for a listed company and there are obvious differences between the two models, but the Panel is of the view that there should not be instances where the governance standards applicable to super funds fall below those applying to listed companies. This might ultimately lead to the question whether a code of practice like the Australian Securities Exchange (**ASX**) Corporate Governance Council's Principles and Recommendations should be developed for super funds and their trustees.[15]

14 For example, Australian Institute of Superannuation Trustees submission page 25, AMP submission pages 7 to 10, AXA submission, pages 6 and 7.

15 ASX Corporate Governance Principles and Recommendations – 2nd Edition August 2007 — http://asx.ice4.interactiveinvestor.com.au/ASX0701/Corporate%20Governance%20Principles/EN/body.aspx?z=1&p=-1&v=1&uid=.

6.2 Trust model

Few submissions seriously questioned the continued relevance of the trust model.[16] That might in part reflect a belief that the costs of changing from such a model would be considerable, but many submissions identified features of the trust model that make it attractive in the superannuation context, including:

- the separation of legal and beneficial ownership (which protects both member and government interests);
- the substantial body of well-established principles that are inherent in the trust concept; and
- the flexibility inherent in the trust model as it can be used in many commercial contexts where it is convenient to separate actual ownership from day-to-day control of the underlying assets.[17]

On the other hand, some have identified the trust's flexibility as a source of risk.[18] Trust law is, for instance, quite lenient on the standards of expertise required of trustees.[19] Similarly, in trust law more generally the largely unfettered ability of the settlor to specify the terms of the trust deed can be used to curtail the rights of members in ways that might be inconsistent with the policy objectives behind compulsory superannuation.

Statute is available as a means to manage this inherent flexibility.[20] The SIS Act presently deems rules imposing certain minimum standards of trustee behaviour to be included in the governing rules of every regulated superannuation fund[21] and requires that super fund assets be applied for the 'sole purpose' of providing retirement benefits.[22] The SIS Act also regulates the acquisition of 'in-house' assets,[23] requires the trustee to formulate risk management strategies and plans,[24] imposes a licensing regime[25] and imposes a set of specific administrative duties on trustees.[26]

Submissions also indicated that the 'trust model' means slightly different things to different people and that there is no common understanding as to what the 'trust model' entails. At one end of the spectrum, the 'trust model' is highly paternalistic; beneficiaries enjoy the

16 This experience mirrors that in earlier reviews. See for instance Law Reform Commission, *Collective Investments: Superannuation*, Companies and Securities Advisory Committee, Report No.59, (National Capital Printing, Canberra, 1992) at para 9.2 and in analogous circumstances in the United Kingdom see *Report of the Pension Law Review Committee (the Goode Report): fourth report of the Social Security Committee together with the proceedings of the Committee. HMSO,* (1993).
17 Sin, K F 1997, *The Legal Nature of the Unit Trust*, Oxford.
18 Clark, G 2008, Pension Fund Governance: Expertise and Organizational Form, In Evans, J, Orszag, M and Piggott, J (eds.), *Pension Fund Governance. A Global Perspective on Financial Regulation*, Cheltenham.
19 Donald, M S 2009, 'The competence and diligence required of trustees of a 21st century superannuation fund', 37 *Australian Business Law Review* 50-62.
20 Getzler, J 2002, 'Legislative incursions into modern trusts doctrine in England: The Trustee Act 2000 and the Contracts (Rights of Third Parties) Act 1999', 2 *Global Jurist Topics* Art. 2.
21 Section 52, SIS Act.
22 Section 62, SIS Act.
23 Part 8, SIS Act.
24 Parts 2A and 2B, SIS Act.
25 Part 2A, SIS Act
26 Part 12 and section 116, SIS Act.

protection of a trustee acting in a full and wide-ranging fiduciary capacity. At the other end of the spectrum, the interests of the beneficiary and responsibilities of the trustee are closely defined in the trust instrument and paternalism is largely circumscribed.

The choice architecture model accommodates this diversity as it permits different statutory requirements to apply to trustees of funds catering to universal members and trustees of funds catering to choice members. This would include removing the current ambiguities that exist for members who might misunderstand the extent to which the 'trustee' of their fund is looking out for them.

The choice architecture model acknowledges that superannuation has a public policy purpose and that universal members should be given particular protection. However, it would also accommodate the modern context of superannuation and allow choice members to make commercial arrangements with trustees about the management of their superannuation.

6.3 Codification of duties

One aim of the SIS Act was to remove any ambiguity about the roles and duties of trustees of super funds by clarifying the obligations imposed on trustees by trust law.[27] This is sometimes mistakenly described as 'codification'. Codification means, as a matter of law, that a statute restates **all** the relevant statutory and case law 'so as to become the complete statement of law in that area'.[28] In so doing, it replaces all previous law on the point and, consequently, the general law cannot be used to assist in interpretation unless there is ambiguity in the statute. This was not the intent of the SIS Act.[29]

Key trustee duties are codified in some other jurisdictions, most notably the United States.[30] Codification is also a feature of most civil law jurisdictions, such as exist in most European countries and in Japan. However, submissions strongly opposed codifying trustee duties for Australian superannuation funds because of the potential for uncertainty if the codification were imperfect or incomplete in any respect.[31] Further, there was no specific evidence proffered that trustees had particular difficulty in understanding or applying their duties as currently required by the general law and section 52 of the SIS Act. The Panel therefore does not believe that 'codification' of trustee duties is required.

This is not to say that the current list of trustee duties in the SIS Act is perfect. There was concern expressed in some submissions[32] that the position of trustees and their directors on conflicts of interest and duty was not clear, especially as section 52 of the SIS Act does not specifically mention conflicts of interest and duty. The conflicts issue is complex and goes beyond the issue of statutory drafting. It is therefore dealt with separately in more detail below.

27 *Strengthening Super Security* (1992).
28 'Codifying Act', Encyclopaedic Australian Legal Dictionary.
29 Law Reform Commission 1992, *Collective Investments: Superannuation*, Report no. 59, at 9.16.
30 Employee Retirement Income Security Act 1974 (US).
31 Law Council of Australia submission, page 10. See also submissions by Mallesons Stephen Jaques, page 3.
32 AXA submission page 7; CBUS submission page 3; ASFA submission page 9.

Several submissions identified that some trustees were unsure of the extent of their duty to those members who had exercised an investment choice within their fund.[33] APRA articulated its view on this in *Superannuation Circular No. II.D.1: Managing Investments and Investment Choice* (2006). A recent report of the Parliamentary Joint Committee on Corporations and Financial Services recommended that APRA revisit the way it expresses this view to make its practical application clearer.[34] The Panel believes that a statutory solution might be required to give industry participants the certainty they desire. It is interesting that the regulatory regime in the United States provides liability relief to a trustee when a member exercises investment choice and those choices meet the 'safe harbor' requirements in the Employee Retirement Income Security Act 1974.[35] The Panel believes that this is a proper result for trustees and the choice architecture model would provide something similar for trustees operating in the choice model.

There are also ambiguities in some cases resulting from the overlay of Corporations Act directors' duties on the SIS Act trustee duties. This is because the trustees of most super funds (excluding SMSFs) are corporations, and the active individuals are strictly speaking, directors of the corporation. The Panel believes there is an opportunity to simplify the regulatory structure by removing one layer and creating a single set of statutory duties owed by the directors of a corporation acting as trustee of a superannuation fund.

Lastly, the Panel supports amending the SIS Act so that it sets out clearly the trustee duties that arise with respect to 'universal' members and 'choice' members recognising that these might differ in important respects.

6.4 Trustee knowledge, skills and training

Submissions generally suggested that a higher standard of knowledge and skills for trustee directors would be beneficial to members and the industry. The Panel agrees with this suggestion. Specifically, it believes that while individual trustee directors do not have to be technical experts across all aspects of superannuation, they must be able to understand and address effectively the issues they encounter as trustee directors. They must be capable of setting the business, investment and operational strategies of the fund and overseeing its operation. This is consistent with the current requirement in the SIS Act that trustee directors exercise the care, skill and diligence of a prudent person in the administration of the trust.[36]

The Panel does not believe that regulation should impose a requirement that trustee directors have any particular academic, professional or other qualifications. Requiring that would-be trustee directors demonstrate a suitable level of level of skill prior to election would run counter to the inclusive ethos of representative boards. However, several submissions[37] expressed interest in regulatory prescription of a certain knowledge and level of skills for all directors within a short period of joining a trustee board (along the lines of the

33 BT Financial Group submission page 11; AXA submission page 7.
34 Parliamentary Joint Committee on Corporations and Financial Services 2007, *The structure and operation of the superannuation industry*.
35 Section 404(c) Employee Retirement Income Security Act 1974 (US).
36 Section 52(2)(b).
37 ASFA submission appendix 1 pages 13-14; AIST submission pages 11 – 12; SPAA submission page 7; Ernst and Young submission; and Law Council submission page 13.

UK system).[38] The Panel agrees with this suggestion. Where there is no election to office, the Panel believes that a potential director should have met the statutory requirements before assuming office.

6.5 Performance measurement

Judging a trustee's performance is a complex matter because many factors have to be weighed. In many cases, relevant information is not readily available. However, the Panel believes that there ought to be more emphasis in making such assessments about trustees so as to promote efficiency and equity in the system.

Many submissions recognised that trustee performance should be measured by more than the fund's return to members, although all acknowledged that returns were an important indicator. The Panel agrees that the actual 'return to members' is perhaps the single most significant indicator of trustee performance as such return captures both investment performance and the trustee's management of costs and expenses. The Panel endorses the development of a methodology that will provide consistent and meaningful information to members on the trustee's investment performance for universal members and choice members.

The Panel is of the view that regard must also be had for the objectives of the superannuation fund; the individual circumstances of different funds (especially those responsible for defined benefit schemes) may result in quite different investment objectives being appropriate. It is net performance relative to these objectives, measured over a relevant time period, that matters.

Many submissions suggested that trustee directors (along with management) should undergo an annual performance review, perhaps covering issues prescribed by an industry body or the relevant regulator.[39] As a matter of good governance, the Panel believes that all trustees should have a standing committee charged with overseeing the performance appraisal of senior management as well as the board itself.

6.6 Accountability to members

The Panel is also concerned that superannuation fund trustees are not sufficiently accountable to members. While there are several reasons that have caused this result, one major reason is the fact that trustees are, as a matter of general law, not required to be accountable to beneficiaries in a way which the Panel believes would be desirable for superannuation fund members. The Panel recognises that the members of superannuation funds are not 'volunteers' in the sense that that term is used in trust law; members provide 'consideration' in the form of the contributions they make and, once in the fund, those contributions are preserved until the member reaches retirement age. The Panel is considering alternative ways to make trustees of super funds more directly accountable to members.

38 Sections 247-249 Pensions Act 2004 (UK); see also, http://www.thepensionsregulator.gov.uk/trustees/trusteeKnowledge/index.aspx.

39 Corporate Super Association submission page 5; AIST submission page 13; ACTU submission, pages 7-8; and ASFA submission pages 16-17 (every three years).

The Panel views disclosure as one important way in which trustees can be made accountable to members: that is, specific information must be given to members. However, it also recognises that disclosure on its own is ineffective if members are not engaged or sufficiently financially literate to use the information effectively. Regard must therefore be had to the context in which the disclosure is made, which may imply distinct rules in the universal and choice models. The content of what must be disclosed in these different circumstances is an important part of Phase Two of the Review.

In order to provide further accountability to members, the Panel is currently minded to recommend a change to the SIS Act so that trustees are required to give reasons for any decision when the trustee is responding to a member complaint. The Panel understands that many trustees already provide reasons. However, in the interests of transparency and accountability, the Panel believes that production of reasons for trustee decisions concerning complaints would not be an undue burden for trustees, nor unreasonably delay a decision regarding the complaint.

The majority of submissions did not support having annual general meetings for members as a way of increasing the accountability of trustees.[40] The Panel agrees.

6.7 Apprehension of personal liability

Most of the submissions thought that trustee directors were not hampered in their activities or decisions because of an apprehension of personal liability. However, some submissions[41] and stakeholder conversations did mention the difficulty trustees were having in finding affordable and suitable indemnity insurance.

6.8 Composition of the boards and succession planning

As noted above, the Panel is of the view that governance principles specific to superannuation funds should be developed. Consistent with the choice architecture model, the Panel expects that there would be more than one set of principles depending on what the trustee is licensed to do and what types of members it is responsible for.

While the Panel does not believe that size of the board or length of tenure for directors should be prescribed, the Panel is of the view that more scrutiny should be given to these factors by the regulator and the boards themselves. The Panel would support the approach of having the governance principles address these practical issues and if a trustee wanted to depart from those principles, the trustee would disclose its reasons for doing so. For example, if it were a principle that a trustee board consist of less than ten directors, a trustee with more than nine directors would have to explain why it had departed from the principle.

6.9 Reliance on outsourcing

Outsourcing of material functions of the trustee has been a hallmark of the Australian superannuation industry. There are many reasons for this. For example, when there was a preponderance of corporate funds, employers often made their resources available to assist the trustee with the administration of the corporate fund so that costs to employees could

40 ASFA submission, appendix 1 page 20; IFSA submission page 48; and SPAA submission page 15.
41 Mercer submission page 31.

be contained. In other contexts, related parties were often used (or established) to provide services to a particular fund or to a group of funds. In other models, there were not the available skills or resources to perform all the required services cost effectively.

One problem with outsourcing is that the trustee must be vigilant that it does not become so reliant on the outsourced service provider that it becomes unable to assess the provider's performance adequately. Taken to the extreme, the provider could usurp the trustee's function in respect of important aspects of the fund's operations.

As the industry matures over the coming decade and greater economies of scale are achieved, the Panel expects that this situation will change and that there will be more selective outsourcing by trustees. While outsourcing increases the operational risk for the fund, it reduces the likelihood of that risk being borne solely by the trustee. Accordingly, there must be a balance struck by the trustee as to how operational risk is managed and whether the trustee is capable of handling the particular operational function (and the attendant risks) by itself.

6.10 Conflicts of interest and duty

The law is very clear that fiduciaries cannot put themselves in a position where their duty as a fiduciary conflicts either with their own personal interests or with a duty owed to a third party.[42] In the superannuation context, this principle is directed towards protecting member interests.

A few preliminary, technical points need to be made. First, though the term 'fiduciary' is widely used, and was used by the authors of many of the submissions, its technical meaning is far narrower (and with far greater consequence) than its lay meaning. Second, it is sometimes assumed that once a person is identified as a 'fiduciary', then a set of pre-defined duties necessarily follows. In fact, it is the other way around; a person is regarded as a 'fiduciary' because of the duties that are imposed in the particular relationship.[43] These nuances have important practical implications.

Market realities pose several challenges to a more widespread application of the fiduciary principle to protect member interests. First, not all participants in the superannuation system are appropriately characterised as 'fiduciaries.' Under current law, only the trustee of the fund is a fiduciary and has the consequent obligations to fund members and beneficiaries. One of the fundamental issues facing the Review therefore is whether (and to what extent) fiduciary obligations ought to be imposed more broadly on service providers. The Panel is working towards a clarification of which participants in the system are 'fiduciaries' and the consequences that designation should attract in each case. The Panel notes the recommendation of the Ripoll inquiry that financial advisers be required to act in the 'best interests' of their clients.

Second, the trust deeds and governing rules of many superannuation funds are drafted to define (and limit) very carefully the duties owed by trustees to fund members. With few exceptions, the SIS Act allows this to happen.[44] One example of this is the practice of

42 *Keech v Sandford [1726] 25 ER 223*; *Boardman v Phipps* [1967] 2 AC 46.

43 Finn, P D 1977, *Fiduciary Obligations,* (Law Book Co, Sydney.

44 One example is section 56(2)(a) which voids any provision that has the effect of exempting a trustee from liability for certain breaches of trust, or of indemnifying a trustee for the same.

specifying key service providers in the deed, thereby removing the selection of service providers as a subject of trustee discretion and hence the possibility that the trustee can be said to face a conflict. Proponents of this practice argue that it facilitates vertical integration and contains costs for members; opponents argue that it prevents the trustee pursuing the best service or price package (or both) on behalf of members.[45]

More generally, there is a need for greater focus on the mechanisms for dealing with conflicts throughout the system. Some areas (in addition to those noted above) where the potential for conflicts arise are:

- Fund mergers;
- Related party transactions;
- Remuneration of directors on trustee boards;
- Appointment of 'independent' trustees who are related to a potential service provider; and
- Holders of multiple trusteeships, where those funds may compete.

There is complexity inherent in all of these examples. The Panel believes that simple exhortations to 'avoid conflicts' are naïve and counter-productive. Similarly, disclosure to members is not an adequate response, given the timeframes involved, the knowledge needed to understand the implications of a conflict and the disengagement of many members in any event.

The choice architecture model can assist in this regard as it recognises that the role of the trustee is different across the various sectors and, accordingly, the duty to avoid conflicts may only be relevant in the disconnected and universal sectors.

6.11 Complexity

The superannuation system is undoubtedly complex, but the notion of saving for retirement is a simple one. The system is comprised of a wide range of products, service providers and complex legislation and regulation (including complex taxation arrangements). Submissions particularly noted the volume and pace of change of legislation, and the multiple regulatory regimes with which trustees need to comply. In addition, the Government has indicated that it wishes to use this Review and the Henry Review as a means of settling a stable policy framework for superannuation that can endure for years to come and which minimises the need for constant regulatory change.

The Panel sees reducing complexity and providing a stable regulatory foundation as key goals. The Panel considers there is no single measure that can achieve this: rather, it will seek to identify means of simplifying arrangements throughout the system.

Some submissions proposed there be a single regulatory body for superannuation, subsuming relevant responsibilities from APRA, the Australian Securities and Investments

45 Equivalently, some funds co-own service providers such as investment advisers or administrators. In this case, there is technically less concern about conflicts of interest, but the potential for members to receive services of a standard below best practice still exists.

Commission (**ASIC**) and the Australian Taxation Office.[46] On the other hand, some favoured the current arrangements, while the Association of Superannuation Funds of Australia proposed that, if there were to be change to current arrangements, there should a be a single regulator across the financial services industry.[47] The Panel does not favour, on balance, the establishment of a single superannuation regulator. The current 'twin peaks' model of regulation has served Australia well through the global financial crisis, allowing APRA and ASIC to concentrate on their respective responsibilities across the financial system. Moving to a single regulator would, in itself, have only a limited impact on regulatory costs and complexity, and would entail not only some risk in terms of future regulatory effectiveness, but also considerable cost and disruption. However, as the Review identifies any specific overlaps, the Panel will consider how these might be resolved. This might include increased cooperation between regulators on compliance or reducing the reporting requirements of trustees.

There is also a raft of legislation that has complex legal application to superannuation funds and trustees. While rationalising superannuation legislation would be ideal in principle, the Panel believes that this should be addressed on a case-by-case basis by considering the underlying purpose of each part of legislation. The Review will, therefore, be seeking to identify any redundant or unnecessarily complex legislation as it carries out its work.

6.12 Consolidation of funds

The Panel does not believe that consolidation should be prescribed. Instead, the Panel believes that consolidation of many smaller funds will occur as a matter of course as it has in the past, especially if further legislative changes occur as a result of the final recommendations of the Review.

Nonetheless, one possibility might be a governance principle that requires funds below a certain minimum asset size to explain their position in relation to scale (eg that they do not accept that merging or increasing scale would benefit members; that they believe their current size is adequate (giving reasons) or that they are actively pursuing a particular growth strategy etc). In other words, an 'if not, why not' obligation relating to scale.

7. GOVERNANCE ISSUES RAISED, BUT NOT TO BE PURSUED

This is a non-exclusive list of the issues raised by the Panel in the Phase One: Governance Issues Paper that it now does not propose to pursue:

Government-directed investing: The Panel recommends that the government not be involved in directing trustees how to invest superannuation fund assets. The Panel does not believe that there is a compelling reason for the government to be directly involved in setting benchmarks for trustees in this area.

UN Principles for Responsible Investment (UNPRI): The Panel does not believe that UNPRI adoption should be prescribed and, accordingly, makes no recommendation in this regard.

46 Corporate Super Association submission page 7, Law Council of Australia submission page 2.
47 ASFA submission appendix 1 page 17.

Tilt toward equities: Subject to any Panel recommendations regarding asset allocations in the disconnected and universal sectors, the Panel sees no reason to pursue this issue.

Portfolio rebalancing: The Panel does not propose making a recommendation about portfolio rebalancing. It is a matter for trustees.

Stock lending: The Panel does not believe that there should be a restriction on stock lending and makes no recommendation in that regard. However, the Panel believes that there should be better disclosure to members about the trustee's policy on stock lending, the risks involved (if any) and the fees it derives from and pays for that practice. Disclosure should also be made about who retains voting power over the securities.

APRA regulation: The Panel recommends that APRA not be given a standards-making power with respect to superannuation. This is because APRA has the power to make operating standards under the SIS Act through regulations and APRA has powers available to it under the RSE licensing regime that it has not yet exercised.[48] Other submissions suggested that separation of powers needed to be observed so that the entity that sets the law is not the same entity that enforces it.[49] Key overseas regulators[50] have well established rule-making powers, but the Panel was not convinced that APRA required such a power.

2007 PJC Inquiry: The Panel believes that recommendation 6 (tendering of all service provision agreements) is unworkable.

There might be other issues raised in the Phase One: Governance Issues Paper that will not develop into recommendations. This list only represents those issues that the Panel has already decided not to pursue.

48 Law Council of Australia submission page 21.
49 Corporate Super Association submission page 7.
50 The Financial Services Authority in the United Kingdom and the Securities and Exchange Commission in the United States, to name two.

8. APPENDIX 1

Key assumptions underpinning the 15-year scenario

A number of assumptions have been made when forecasting the size and structure of the superannuation system over the coming 15 years. These forecasts do not assume any increase in contributions, earnings or policy changes as a result of this Review. The key assumptions underlying the forecast are:

- All real forecasts have been calculated using 2009 as the base year with the consumer price index measuring 2.5 per cent per annum thereafter.

- In real terms, total superannuation assets are assumed to grow at an annual average of about 4.8 per cent from around $1.08 trillion in 2009 to about $2.2 trillion in 2025. Small funds, including SMSFs and small APRA funds, will grow to slightly more than a third of total superannuation assets.

- The number of superannuation funds is expected to continue to decline as funds consolidate. The number of APRA-regulated superannuation funds will reduce from 447, excluding ERFs, in 2009 to 119 in 2025.

  - The number of industry funds and retail funds will continue to decline at the same average rate (around seven per cent per annum) they have since 1996. It is projected there will be 21 industry funds and 47 retail funds in 2025.

  - The number of public sector funds will decline at two per cent per annum, the average rate experienced since 1996, excluding the two outlier years experienced after the introduction of the Registrable Superannuation Entities (**RSE**) licensing requirements which saw a large reduction in the number of public sector funds. It is projected there will be 29 public sector funds in 2025.

  - The number of corporate funds has declined, on average, by 20 per cent each year from 1996 to 2009. It is projected this rate of decline will slow, such that by 2025 there will be 22 corporate funds.

- The 2025 financial year average market capitalisation of domestic listed equity was calculated using the historical trend of the ASX as a proportion of GDP over the past 17 years.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