Summary

Introduction

The report arises out of a joint reference to the ALRC and the Companies and Securities Advisory Committee (the Review) to examine prudential supervision and other regulatory issues associated with prescribed interests and other 'collective investments'. On 4 September 1991, the Attorney-General wrote to the Review requesting an interim report on superannuation, which is a kind of collective investment. The report covers a range of issues relating to the prudential supervision of superannuation and the rights and interests of members of superannuation schemes.

Collective investments and superannuation

'Superannuation' generally refers to the payment of a benefit to a person upon retirement from employment. Superannuation schemes may be classified as personal schemes or employer related schemes. Schemes may also be divided on the basis of the benefits provided: defined benefit schemes (where the benefit to be received by the member is fixed, usually as a multiple of average salary over the last few years of employment) and accumulation schemes (where the amount of benefit depends on the investment performance of the scheme). Superannuation also includes specialised rollover funds such as Approved Deposit Funds (ADFs) and Deferred Annuities (DAs) which enable employees who receive a payment on termination of employment prior to retirement to defer any tax liability.

Making superannuation safe

With the introduction of the Superannuation Guarantee Levy legislation and the gradual increase in compulsory employer funded superannuation contributions from 3% to 9% of employee earnings, the government will transform superannuation from a voluntary collective investment used by a minority of the workforce to an almost universal, compulsory retirement savings policy. Because of the element of compulsion, the government and the community have a strong interest in ensuring that the investment of those funds is secure and successful. The Commonwealth has recognised the need to provide an appropriate prudential framework to back up its official encouragement of superannuation. This framework will need to take into account the need

- to protect retirement savings and maintain public confidence in superannuation schemes
- to take account of the importance of superannuation funds to the long-term development and stability of the economy

- to resolve the issue of how to deal equitably with schemes that collapse through dishonest or inefficient management
- to ensure that the highest degree of integrity is maintained by the operators of schemes that enjoy the privilege of tax concessions.

Should superannuation schemes be insured?

An alternative to prudential supervision to minimise the risk of superannuation schemes failing is to require them to insure themselves against failure. The report found that mandatory insurance of superannuation benefits would not be practicable in the Australian context. Instead, it recommends that those who operate superannuation schemes be encouraged to insure against loss due to negligence and fraud.

Achieving consistency in regulating superannuation

Different regulations apply to different kinds of superannuation schemes. Which regulations apply depend on the way the scheme is funded (defined benefit or defined contribution) and on which institution is offering it (for example, life insurance companies or employers). These differences mean that some schemes which appear to be conceptually similar are subject to different regulatory regimes and in some cases to quite different requirements. The five most important areas in which there are differences in regulation are

- solvency requirements
- investment controls
- reporting requirements
- liability
- standards for participants.

These differences are compounded by the fact that the industry is administered by a variety of agencies. The report outlines these differences in the regulation of superannuation schemes and considers whether they are justified. The report's recommendations overcome the inconsistencies between the regulatory regimes covering superannuation schemes. They will ensure that the regulator has effective and appropriate powers.

Who is the regulator

The report recommends that there be an appropriately funded regulator with power to enforce compliance with legal standards by the use of sanctions, and with the aim of protecting and enforcing the interests of scheme members. The regulator should have extensive powers of investigation and audit. The report does not recommend that a particular government agency should have responsibility for regulating superannuation. The focus of this report, and of the collective investment review as a whole, is to make recommendations about the appropriate law and regulatory policies to ensure the stability and security of superannuation schemes. The recommendations in the report can be administered by whatever agency or agencies the government decides should be responsible.

The constitutional basis for Commonwealth regulation

The report deals with the extent of Commonwealth legislative power to impose prudential and other controls on superannuation and other related schemes. The report notes that the principal defect of current controls is that trustees who fail to comply are not directly subject to any penalties or sanctions. The removal of the tax concession penalises members rather than a non-complying trustee. The report concludes that no Commonwealth legislative power, taken alone or in combination with other powers, will completely cover the areas for which provision needs to be made. The report recommends that the regulatory framework for superannuation schemes be strengthened by new enforcement mechanisms, backed up by effective sanctions. It recommends that this be achieved by using taxation incentives to ensure that all superannuation schemes which have more than one member

- are incorporated or otherwise fall within the corporations power or
- offer old-age pensions, within the meaning of the Constitution, as their dominant purpose.

Regulating the players: standards for operators

The success of the Commonwealth's retirement incomes policy will depend to a large degree on the quality and integrity of the participants in the industry. The Review considers that the party which bears primary responsibility to the members of a superannuation scheme should be able to be easily identified in all circumstances. Because of the important position of the responsible entity, the report recommends that individuals and corporations be declared unsuitable to act as responsible entities in certain circumstances, for example, being an undischarged bankrupt, having a receiver appointed or being convicted within the previous ten years of an offence involving dishonesty. A breach should result in immediate disqualification.

Standards for investment managers of superannuation funds

The report does not recommend that investment managers be subject to any prevetting in addition to the vetting that they may be subject to in relation to their actually dealing with funds. However, the report does recommend that an investment manager be considered unsuitable to act for a superannuation scheme on the same grounds as those on which a responsible entity is unsuitable to act. The report does not recommend a minimum capital requirement for investment managers unless they have custody of a superannuation scheme's assets. The report also makes recommendations to ensure that contracts between investment managers and responsible entities of superannuation schemes are fair to the responsible entity and hence do not prejudice the interests of members of the scheme.

Superannuation intermediaries

The quality of advice given to people who are contemplating joining personal superannuation schemes, investing in a single contribution superannuation scheme or rolling over superannuation benefits is an important factor in an individual's choice. The regulation of people who give such advice and sell these products will also be an important element in the success of the Commonwealth's retirement incomes policy. The report is concerned primarily to ensure that standards for superannuation intermediaries, whether they be securities dealers, financial planners or life agents, are adequate and uniform. It recommends changes to achieve this objective.

Distinguishing features of superannuation trusts

While employer related superannuation schemes are structured as trusts, they have some features which differ from traditional trusts. The key differences, most of which have been introduced by Commonwealth policy, are

- beneficiaries are not always volunteers (that is, recipients of a gift)
- there is often an associated contract of employment
- employers have obligations to fund schemes
- employers have a continuing financial interest
- beneficiaries are entitled to representation on trustee boards
- the size of the trust fund is variable
- employers have the power to veto amendments to the terms of the trust

Duties of the responsible entity to be included in legislation

The report focuses on the principal fiduciary duties owed by responsible entities to members of superannuation schemes. The report recommends that they be expressly included in statute as obligations from which a responsible entity cannot be excused by the governing document of the scheme. All employees require the full protection of the fiduciary duties imposed upon superannuation scheme responsible entities. The report recommends that the law include a set of fiduciary obligations for responsible entities of superannuation schemes, ADFs and PSTs. The duties should be paramount — if they conflict with other conditions of the governing document, the other provisions should be void. The report recommends that the following duties of a responsible entity should be included in legislation

- duty to hold property for the benefit of members
- duty to become familiar with the deed and interpret the deed or other rules fairly
- duty to act honestly
- duty to avoid conflicts of interest and to fully disclose such conflicts
- duty to act always in the best interests of the members of the scheme
- duty to exercise care, diligence and skill
- duty to keep trust money separate from the employer's assets
- duty to exercise discretion only after proper consideration
- duty to act on advice
- duty to act personally and not to delegate
- duty not to profit from the trust
- duty to monitor the cash flow of the scheme
- duty to take a portfolio approach to investment
- duty to permit access to trust documents.

Duty of directors of incorporated responsible entities

The incorporation of a responsible entity will mean that trustees will become company directors. Technically, the company will replace them as trustee. Directors' duties are traditionally owed to the company as a separate legal entity. The establishment of such a corporation should not, however, mean that the directors of that corporation no longer stand in a fiduciary relationship to the beneficiaries of the scheme. Because the responsible entity's sole function is to manage the superannuation scheme on behalf of the members, the directors of a corporate responsible entity should be personally liable to the beneficiaries of the scheme, as they would be if the responsible entity was not incorporated.

Importance of disclosure

In the context of superannuation schemes, disclosure is important in three respects

- to prospective members, particularly of personal schemes
- to existing members of all schemes during membership of the scheme and on exit from the scheme
- to the regulator to enable it to monitor compliance with the law.

Consistency of disclosure requirements

The report sees the requirement for adequate disclosure as the fundamental requirement of any system of prudential supervision. The report endorses the disclosure requirements under the Corporations Law s 1022 as an appropriate standard to apply to disclosure for all superannuation schemes. The report recommends that all superannuation schemes should conform to that standard of disclosure.

Comprehensible information

Information must be comprehensible as well as consistent. There is little point in disclosure which uses technical jargon or sophisticated concepts not readily understood by the community. Consequently, the report recommends that information about prospective benefits should be reported to members in real terms, that is, in present day dollar values, and in clear, easily understandable language.

Advertising

The Review is strongly of the view that it is important to regulate advertising to ensure that a product or service provider does not mislead prospective investors and that the information provided is truthful and realistic. In the case of superannuation schemes this includes the information about the likely payments to be made to members. Advertisements should also clearly identify the responsible entity.

Disclosure to existing members

The Treasurer's statement of 20 August 1991 contained extensive disclosure requirements. The report endorses the need for requirements such as a comprehensive annual report and full disclosure of fees and charges. In addition to the Treasurer's proposals, the report recommends the following:

- disclosure to members of single investments of more than 5% (instead of 10%)
- reporting the superannuation scheme's performance over the past five years (instead of three)
- reporting the scheme's investment strategy over the next five years and performance against that strategy.

Investment controls

The report recommends that there should be no rule requiring specific asset allocation by superannuation schemes. In addition to the current investment controls, the report recommends that

- the limit on in-house investments be reduced from 10% to 5%
- the use of futures, options and derivative instruments should be restricted

- the responsible entity should be required to monitor the realisable assets of the scheme and report annually to the regulator on whether the expected liabilities of the scheme in the year ahead can be met without recourse to borrowing
- the same investment controls that apply to superannuation schemes should apply to PSTs.

In addition to these investment controls, the report recommends that the current restrictive approach by the courts in assessing the riskiness of investment activities of superannuation schemes should be changed to take into account the risk profile of the whole portfolio of investments.

Members' rights

The report recommends that scheme members have access to information held by their superannuation scheme. The report also enhances the rights of members to participate in the management of superannuation schemes by recommending that all schemes with 50 or more members should have equal employer and employee representation on the responsible entity. Members should also have the right to dismiss the responsible entity in certain circumstances. The report recommends that access to superannuation should be improved by reducing qualifying periods and vesting scales for superannuation contributions in excess of the level to be required under the proposed SGL legislation.

Advice and internal dispute resolution systems

As superannuation coverage increases, more and more people will be dealing with superannuation for the first time. The report recommends the establishment of an advisory service to ensure that members have access to accurate information regarding superannuation. The report also recommends that superannuation schemes be encouraged to establish internal dispute resolution mechanisms.

External dispute resolution mechanism

The report notes the Treasurer's reference to the need for a low cost alternative dispute resolution mechanism for superannuation. It recommends that a Review Panel be established, with powers equivalent to those of a court to hear disputes between members and responsible entities of superannuation schemes. The Review Panel should provide a cheaper alternative to review by the courts.

'Lost' members

The report recommends that procedures be established by each superannuation scheme to identify members it has lost contact with. It recommends that funds credited to the accounts of such members should be transferred to an Unclaimed

Benefits Scheme (UBS) two years after it is established that the member cannot be located. The UBS will be a group of privately administered, privately invested funds with a central register. This will ensure that members can easily reclaim their entitlements.

Superannuation on divorce

The report recommends that the Family Court should be given the power to order the re-allocation of superannuation entitlements of parties applying for divorce to ensure that the financial resources of the parties to a marriage can be more equitably divided between them. The orders should be binding on the responsible entity.

Powers of the regulator

The regulator will play a crucial role in ensuring the adherence to the prudential standards recommended in the report. The regulator will need to be adequately funded and have extensive powers of investigation and audit. The report recommends that the regulator have the power to take action (including representative action on behalf of scheme members) against the responsible entity.

The role of auditors

Even with an effective regulator, it is not possible to closely supervise the activities of all superannuation schemes. The report recommends that auditors should play a much greater role in the prudential supervision of superannuation schemes. It recommends that auditors be required to report to the regulator on the compliance with prudential standards by superannuation schemes. Only auditors that have undertaken special courses should be permitted to audit superannuation schemes.

Surpluses and reserves

The report includes recommendations to clarify the current confusion relating to surpluses. It recommends that no more than 50% of a surplus may be returned to an employer at any time. The report notes that there is some uncertainty about the ability of superannuation schemes to establish reserves without committing a breach of trust. The report recommends that reserving be allowed.