11. Investment controls

Introduction

11.1. As a result of the Commonwealth's retirement incomes policy, there is expected to be a considerable growth in the money available to superannuation scheme managers.[1] A significant issue in prudential supervision is what (if any) investment controls should be placed on superannuation schemes, ADFs, PSTs and DAs. Currently there are very few controls over how superannuation schemes invest their funds. This chapter reviews the current investment controls on superannuation schemes and examines the rationale for imposing such controls. It makes a number of recommendations that take into account both the need to protect the interests of investors and market efficiency goals.

Current investment controls

Statutes

11.2. ***Life Insurance Act.*** As noted in chapter 6 the *Life Insurance Act 1945* (Cth) imposes investment controls on life companies. These controls are imposed for prudential purposes to ensure life insurance companies have the capital reserves to withstand the mortality risks their business faces.

11.3. *OSSA.* Chapter 5 also notes that the OSS Regulations set out a number of restrictions on the investment activity of superannuation schemes and ADFs. These controls are also imposed for prudential purposes.[2] They must be observed if the scheme is to obtain a concessional tax treatment.

Other controls

11.4. ***Trust deeds***. In addition to the investment controls imposed by OSSA, a superannuation scheme may be restricted in its investment activities by the terms of its deed, or other establishing instrument, although generally a wide investment power is conferred on the trustees of superannuation schemes. If the deed or instrument is silent on the matter of investment powers, the superannuation scheme is restricted to investments authorised by State and Territory Trustee Acts.[3]

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1. See para 1.6, 2.3.
2. Treasurer's statement, paper 1 para 15.
3. These investments are either specifically prescribed or limited to securities which meet a prescribed investment rating.

11.5. ***Common law.*** As discussed in chapter 9, the common law fiduciary obligations of trustees also impose restrictions on the investment activities of trustees. Chief among these is the requirement that a trustee of a superannuation scheme, PST or ADF must act prudently when making investments.

> The duty of the trustee is not to take such care only as a prudent man would take if he had only himself to consider, the duty is rather to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.[4]

The rationale for investment controls

Introduction

11.6. From time to time investment controls have been proposed for superannuation schemes for the following reasons:

- to achieve national investment objectives
- to reduce institutional risk and
- to ensure prudential standards are maintained.

The justification for these objectives and the means by which they can be achieved are discussed below.

Achieving national investment objectives

11.7. ***Investment in national interest projects.*** It has been suggested that superannuation schemes should be directed to invest a proportion of their funds in projects which are in the national interest but are unable to attract funding on a commercial basis. Such projects include low cost housing, infrastructure projects like the Very Fast Train project and high risk projects (for example, so-called venture capital projects). Such investment controls are often justified as a trade-off for the substantial tax concessions received by complying superannuation schemes.[5]

11.8. ***The Review's assessment.*** The primary objection to requiring superannuation schemes to invest in certain national projects is that it will lower their returns. This would be contrary to the Commonwealth's retirement incomes policy objectives. If a national project provided rates of return appropriate for the risk involved, then the market would allocate funds to that project without it

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4. *Re Whiteley; Whiteley v Learoyd* (1886) 33 Ch D 347, 355 (Lindley LJ).
5. The investment income of complying funds is taxed at only 15%.

being prescribed. This does not happen because the project does not represent an efficient use of capital for the risk involved. If investment in such projects is only possible by prescription, then, by definition, the funds invested represent an inefficient use of resources from a superannuation scheme's point of view. It may be argued that prescription is necessary in some cases because the investment will provide social benefits which will not be reflected in the market rate of return offered to investors in the project. However, to force superannuation schemes to invest in such projects for a sub-commerical rate of return means that members of superannuation schemes would be forced to bear the social cost of such projects, not the community as a whole. If the community as a whole is to benefit from such projects, the community as a whole should pay for them. Therefore, the Review does not accept that this is a justifiable reason for imposing investment controls on superannuation schemes.

Reducing institutional risk

11.9. ***Using more than one manager.*** It has been suggested that the safety of larger superannuation schemes would be enhanced if they were required to use more than one investment manager.[6] This would reduce the risk that any one manager chosen could, through failure or incompetence, seriously diminish the value of a scheme's funds.

11.10. ***The Review's assessment.*** The use of a variety of external investment managers may reduce the institutional risk facing the scheme that the managers selected will fail. It will not, however, increase the diversification of the scheme's assets unless the investment managers have different investment strategies. It may, however, be prudent for the trustees not to rely on the advice of only one manager. The Review considers that the recommendation set out in chapter 9 in relation to the responsible entity's fiduciary obligations to the members of the scheme should be adequate to ensure that, if it is prudent to do so, more than one manager will be used. To require responsible entities to use a specified number of investment managers may expose the Commonwealth to claims for responsibility for the investment results. Accordingly, the Review does not accept this as a useful investment control for superannuation schemes.

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6. eg Attorney-General's Department (Cth), *Submission to the Senate Select Committee on Superannuation*, para 55.

Use of external investment managers

Recommendation 11.1: No rule requiring the use of external investment managers

There should be no rule apart from the responsible entity's fiduciary obligations to members of the fund that requires the responsible entity for a superannuation fund, an ADF or a PST to engage an investment manager.

Maintaining prudential standards

11.11. Investment controls to limit the degree of market risk an institution may have, is a common form of prudential supervision designed to provide a level of protection to an institution without guaranteeing a return to investors. As noted in chapter 3, the government accepts the need for such prudential controls on superannuation schemes. The existing controls imposed on superannuation schemes and ADFs under OSSA are accepted by the government as having a prudential purpose.[7] In addition to the current prudential controls on investment the following have been proposed

- imposing maximum or minimum investments in specified asset classes
- establishing a liquidity requirement and
- a requirement to take a portfolio approach.

Maximum or minimum investment in specified asset classes

11.12. *Diversification.* Diversification of a scheme's investments can be ensured by prescribing either a minimum or maximum level of investment in particular asset classes. Under such an approach, the consequences of a decline in the value of any one of these classes of investment is restricted. A requirement that schemes can only hold up to a maximum amount in each asset class would have a similar effect. This latter option would provide responsible entities of superannuation schemes with more control over the investment decision but at the same time require a minimum acceptable level of diversification.

11.13. *Problems.* In DP 50 the Review expressed the view that such a restriction did not have value as a prudential control. Making a superannuation scheme comply with a particular maximum or minimum asset allocation may, instead of lessening the scheme's investment risk, force the scheme to be exposed to a risk it could otherwise have avoided and thereby actually increase the risk level of its

7. Although the Treasurer indicated that the Government does not intend to provide further special investment controls: Treasurer's statement, paper 1 para 30.

investment portfolio. For example, if superannuation schemes had been required to hold a minimum level of assets in property, they all would have suffered an involuntary or compulsory loss in 1990. Similarly, whilst appearing to reduce risk, a prescriptive approach may result in lower investment returns. In the case of maximum asset allocation requirements, a degree of distortion is introduced into investment patterns as schemes acquire assets to meet the asset allocation rules rather than for their investment value to the scheme. This may result in an inefficient allocation of resources. Indeed, previous experience in both Australia and overseas indicates that when investment controls are imposed by the Government, the result is lower returns.[8] The Commonwealth has stated that it does not believe that additional controls on superannuation schemes directing the specific placement of funds in particular assets or asset classes are warranted.[9] In DP 50 the Review agreed, proposing that there should not be any prescription of specific asset allocation for superannuation schemes. This proposal met with overwhelming support in submissions and consultations.[10] The Review recommends accordingly.

Recommendation 11.2: Asset allocation
There should be no prescription of specific asset allocation for superannuation funds, ADFs or PSTs.

Establishing a liquidity requirement

11.14. *Minimum liquidity ratio.* Superannuation schemes should maintain adequate liquidity levels to meet the scheme's current obligations to pay benefits to members.[11] It has been suggested that a minimum liquidity requirement[12] or ratio be imposed on superannuation schemes to ensure that they are able to meet such obligations. The measure most often proposed involves a requirement that superannuation schemes hold a fixed proportion of their assets in cash, or as government or other tradeable debt securities. One instance of such a requirement having been imposed is the so-called 30/20 rule, which was in force

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8. This was noted by BT Asset Management *Submission* February 1992.
9. Treasurer's statement, paper 1 para 30.
10. Australian Investment Managers' Group *Submission* February 1992; Jacques Martin Industry *Submission* February 1992; Superannuation Advisers Pty Ltd *Submission* February 1992; AMP Society *Submission* February 1992; ASFA *Submission* February 1992; ACTU *Submission* March 1992; IFA *Submission* February 1992; Shell Australia *Submission* February 1992; DSS *Submission* February 1992; NSW Superannuation Office *Submission* March 1992; National Australia Bank *Submission* March 1992.
11. Liquidity is used here in a wide sense, as relating to realisable assets.
12. Liquidity requirement is used here in the narrow sense of cash on tradeable securities.

between 1961 and September 1984.[13] Under this rule, life insurance companies and superannuation schemes received a tax concession if they held at least 30% of their assets in public securities with at least 20% of their total assets in securities issued by the Commonwealth.[14]

11.15. ***Problems.*** In DP 50 the Review indicated that its view was that a requirement of a specific ratio of liquid assets, such as government bonds, was inappropriate on at least two grounds. First, it may distort capital markets as schemes acquire securities to meet the ratio rather than their needs, thus increasing the exposure of some schemes to interest rate risk above that which is appropriate to their situation. Second, as argued by the Campbell Committee and the Martin Review Group,[15] forcing schemes to buy Government securities provides the Government with a guaranteed supply of loan funds. If the Government offers a below-market interest rate on its securities because it is guaranteed these loan funds, this will reduce the overall earnings rate of the schemes. As noted above, the imposition of a liquidity ratio on superannuation schemes may result in a scheme being required to hold an unnecessarily high level of liquid assets, with adverse consequences for scheme profits.

11.16. ***Proposal.*** DP 50 proposed, therefore, that only those schemes in which benefits are transferable should have to meet a prescribed liquidity standard.[16] Many submissions suggested that this proposal should be expressed in terms of realisable assets rather than liquidity. Some submissions expressed concern that the proposal was too inflexible to fit all schemes.[17] The Review agrees that the prescription of a liquidity test is undesirable as the need for liquidity can vary significantly between schemes and over time. It considers, however, that it is necessary to provide for appropriate liquidity levels within the context of individual schemes. It therefore recommends that a responsible entity of a superannuation scheme should be required to monitor the cash flow relationship between realisable assets and estimated liabilities to ensure that obligations can be met as they fall due. It is argued that this obligation already exists as one

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13. The 30/20 rule provided a means by which the Commonwealth could reduce its cost of borrowing, and can be regarded as a trade-off for tax concessions. It was abolished by the Commonwealth as it was no longer considered to be a cost-effective way to subsidise public expenditure. Its abolition was recommended in the Campbell Committee Report para 10.23-10.24 and by the Martin Review Group Report ch 9 para 4.2.
14. ITAA s 23(ja), 23F.
15. Campbell Committe Report para 10.26-10.27; Martin Review Group Report ch 9 para 5.8.
16. DP 50 proposal 7.7.
17. eg Australian Friendly Societies Association *Submission* February 1992; Shell Australia Ltd *Submission* February 1992.

of the duties of a responsible entity. To remove any doubt, the Review has recommended that it be clarified as a specific duty of responsible entities.[18] The Review does not recommend that a specific liquidity requirement be maintained.

A portfolio approach

11.17. ***Diversification and prudence.*** It has been suggested that, given the importance of superannuation, it is an appropriate objective of its prudential supervision to try to reduce the level of investment risk by specifying, in general terms, the degree of diversification of investment portfolios held by superannuation schemes.[19] In general, a superannuation scheme that holds a diversified portfolio will carry less overall risk than a scheme that restricts its investments to a few classes of assets.[20] While there are indications that trust law is now recognising the importance of the issue of risk management when assessing the actions of trustees, the courts have traditionally adopted a 'line-by-line' approach and examined the risk and return for each investment in the scheme, without reference to the risk and return of the other investments made by the trustee.[21] This line-by-line approach is inconsistent with modern portfolio theory.[22] As discussed in chapter 9, a fundamental tenet of trust law is that a trustee must act in a prudent fashion when making investments on behalf of superannuation scheme members. Generating an appropriate rate of return is, however, a vitally important objective of a superannuation trust. If a trustee is too conservative regarding investment decisions, the scheme will not earn a high enough rate of return to provide its members with a useful supplement to their publicly provided pension. To select assets broadly in the market, therefore, can be regarded as a prudent strategy, for it reduces the portfolio risk without significantly reducing the rate of return. Thus a strategy of diversification, being a prudent but not overly conservative policy, is appropriate in the superannua-

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18. See recommendation 9.2.
19. In his statement on 20 August 1991, the Treasurer indicated that, while the Government does not intend to prescribe any further specific investment controls of the kind noted above, it will be encouraging superannuation schemes to diversify their investments: Treasurer's statement, paper 1 para 29.
20. A portfolio of shares which holds every kind of share available in the market, in the same proportion as those shares are to the total share markets, represents the ultimate in diversification and its return will mirror the markets return. In practice, however, it is not necessary to diversify to such an extent in order to significantly reduce the diversifiable risk: RA Brealey *An Introduction to Risk and Return from Common Stocks* 113.
21. FJ Finn & PA Ziegler 'Prudence and Fiduciary Obligations in the Investment of Trust Funds' (1987) 61 *ALJ* 329, 333.
22. Modern portfolio theory states that the level of portfolio risk depends not only on the risk of the individual assets but also on the degree of correlation between the assets.

tion context. To the extent that the 'line-by-line' approach taken by the courts ignores modern portfolio theory, the overall risk of the portfolio may be increased without a corresponding increase in return.

11.18. ***Overseas examples.*** This approach has been adopted in the United States and Canada.[23] In the United States, ERISA incorporates the prudent person requirement in connection with trust investments. ERISA requires the fiduciary to act 'with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims'.[24] The ERISA regulations state that the relative riskiness of a specific investment is not the sole determining factor as to whether the action was prudent, but that an investment is to be judged on the basis of the role it plays in the portfolio.[25] Similarly, the American Restatement (Third) of Trusts states

> The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent invester would, in light of the purposes, terms, distribution, requirements and other circumstances of the trust.
> (a) This standard requires the exercise of reasonable care, skill and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.
> (b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.
> (c) In addition, the trustee must;
> (1) conform to fundamental fiduciary duties of loyalty (s 170) and impartiality (s 183);
> (2) act with prudence in deciding whether and how to delegate authority to others (s 171);
> (3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (s 188).[26]

The Review notes that the American Restatement (Third) of Trusts proposes a 'prudent investor' standard rather than a 'prudent person' standard. As discussed in chapter 9, the Review does not consider that a prudent investor standard should be substituted for the prudent person standard traditionally applied to trusts, in particular, superannuation schemes. The Review is concerned that the prudent investor standard imports a degree of investment

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23. See para 9.12, 9.13.
24. ERISA s 404(a)(1)(B).
25. B Coleman *Primer on Erisa* 88.
26. *American Restatement (Third) of Trusts*, s 227. The restatement was adopted by the American Law Institute in May 1990.

expertise which may not be present, particularly in the context of employer related schemes. The prudent investor standard may also be interpreted to encompass a degree of calculated risk which the prudent person standard would not. The Review does not consider that this degree of risk should be promoted in the superannuation context.

11.19. *Legislative change.* To the extent that some Australian courts may still follow the traditional 'line-by-line' approach, the Review considers that legislative amendment is warranted to ensure that trustees of superannuation schemes may, as part of a prudent investment strategy, use portfolio theory. In DP 50 the Review proposed that reliance by responsible entities on modern portfolio theory in the selection of investments should be taken into account in determining whether any single investment constitutes a breach of a responsible entity's fiduciary duties.[27] This means that while each investment decision is examinable, it ought to be examined in the context of the entire portfolio. This should remove potential trustee inhibitions regarding certain investments which would, on a line-by-line analysis, not be prudent. The vast majority of submissions that expressed a view on this issue supported the Review's proposal.[28] However, concerns were noted about what this proposal would mean in practice; in particular, what was meant by a requirement to use 'modern portfolio theory'. This issue has been clarified by the Review in recommendation 9.2.

Should PSTs be subject to investment controls?

11.20. In chapter 6 the Review notes that OSSA imposes investment controls on superannuation funds and ADFs but not on PSTs.[29] The Review considers the scope of investment controls to be an important issue. The consistency of controls across like investments is an essential element of an efficient financial system. The argument for imposing the same kinds of investment controls over PSTs as are placed on superannuation schemes and ADFs is based on the observation that PSTs can only accept funds from tax preferred investors (principally other superannuation schemes). Thus the consequences for the Commonwealth's retirement incomes policy of the collapse of a PST are similar to those of the collapse of a superannuation scheme. It may be argued that, because a PST may have all the funds of several small superannuation schemes

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27. DP 50 proposal 7.2.
28. eg ASFA *Submission* March 1992; LIFA *Submission* March 1992; Permanent Trustee Company Ltd *Submission* January 1992; Jacques Martin Industry *Submission* 1992.
29. Investment standards may be prescribed for PSTs: OSSA s 8A. To date no such standards have been prescribed.

invested in it, the consequences of the collapse of a PST are potentially far more significant than those of the collapse of a superannuation scheme or other collective investment.[30] In DP 50 the Review considered the following options

- no change to the current deregulated approach
- limit the investment that superannuation schemes can make in any one PST
- subject PSTs and like schemes to the same investment controls as superannuation schemes.

11.21. *No controls.* In DP 50 the Review expressed the opinion that, while the current lack of investment controls for PSTs may have been appropriate when superannuation was a voluntary collective investment, it is no longer appropriate. Similarly, the Review did not consider that it is acceptable to argue that a PST is merely a unit trust like any other in which a superannuation scheme may invest because PSTs have a crucial advantage in relation to superannuation schemes which no other unit trust has, namely their ability to pay tax on behalf of superannuation schemes. This sets PSTs and their regulation apart from that of other unit trusts. The Review remains of this opinion.

11.22. *Limited investment in PSTs and like schemes.* This proposition is based on the fact that a PST may only receive contributions from other superannuation schemes or tax preferred investors. It limits the risk each superannuation scheme can take by investing in a single PST by restricting the amount which may be invested in a single PST. In DP 50 the Review suggested that this argument is merely a variation of the maximum investment controls which the Review considered and found inappropriate.[31] The Review considered that it should be rejected for the same reasons. The Review has not changed its opinion.

11.23. *Subject PSTs and like schemes to the same investment controls as superannuation schemes.* The argument, considered by the Review in DP 50, in favour of this proposal is this:

- investment controls on superannuation schemes are appropriate because of the purpose for which funds are put into superannuation schemes

30. It is possible to imagine a scenario where an ordinary collective investment vehicle successfully marketed itself exclusively to superannuation schemes. The consequences of the collapse of such an investment vehicle would therefore be the same as the collapse of a PST. However, the fact that only investment in a PST can relieve superannuation schemes of the need to calculate their tax liabilities makes it less likely that other investment vehicles whose investors are all superannuation schemes, will emerge.
31. DP 50 para 7.25.

- PSTs and like schemes are simply larger superannuation schemes
- PSTs and like schemes should, therefore, be subject to the same investment controls as superannuation schemes.

In DP 50 the Review indicated its acceptance of this argument on the basis that if the current range of investment controls over superannuation schemes are considered appropriate to protect them, why should they not apply to PSTs and other like schemes which can only contain the same kind of tax preferred savings? The Review considered, but did not accept, the argument that PSTs are no different from other investment options open to a superannuation scheme, such as property trusts which are not subject to the same investment controls as superannuation schemes, although they may contain only funds from superannuation schemes. The Review accepted the proposal that, because of the administrative advantages associated with investing in PSTs (namely that all income tax is paid on behalf of the investors in the scheme) a superannuation scheme is likely to invest a larger proportion of its funds in a PST than any other investment offering a similar rate of return. Furthermore, PSTs will only have superannuation scheme funds invested in them, whereas other collective investments are likely to have non-superannuation funds invested in them as well as any superannuation funds it may have. The Review therefore proposed in DP 50 that the prudential regulations applying to superannuation schemes and ADFs should apply to PSTs, and any other vehicle that may only accept investments from superannuation schemes and other tax preferred investment schemes. This proposal received widespread support.[32] Several submissions did not agree that there was a need to regulate the investments of PSTs.[33]

> Trustees can control their liquidity position through the asset allocation process. Placing a further burden on pooled trusts would, in most circumstances, probably result in lower returns to members than would otherwise be obtained if the requirement did not exist.[34]

The Review remains of the view that, for the reasons given, PSTs ought to be subject to the same prudential regulation as superannuation schemes are.[35] PST's are currently subject to fundraising, disclosure and other controls under

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32. AMP Society *Submission* February 1992; National Mutual *Submission* February 1992; Westpac Financial Services *Submission* February 1992; Shell Australia Limited *Submission* February 1992.
33. ASC *Submission* March 1992; D Knox *Submission* February 1992.
34. Jacques Martin Industry *Submission* February 1992.
35. Australian Investment Managers' Group *Submission* February 1992; Australian Friendly Societies Association *Submission* February 1992; LIFA *Submission* December 1991; Shell Australia Limited *Submission* February 1992.

the Corporations Law. These should continue to apply except where they are inconsistent with the prudential standards applying to the use of funds by superannuation schemes. In that case, the latter standards should apply.

Recommendation 11.3: Subject PSTs to the same investment controls
The law should provide that the prudential regulations applying to the use of superannuation scheme funds should apply to PSTs and to any other vehicle that may only accept investments from superannuation schemes and other tax preferred investment schemes.

In-house investment rule

11.24. ***Risks involved in in-house investments.*** An in-house investment is different from other investments of a superannuation scheme. Not only is the judgement of the person making the investment likely to be influenced by the relationship between the scheme and the sponsor. It involves an additional type of risk. If the employer goes out of business, not only will members lose their jobs but their superannuation scheme will suffer a loss which it may not have suffered if it had not invested in-house. In view of this additional risk, DP 50 suggested that in-house investments should not be encouraged, and indeed, should be reduced below their current level. It proposed that the in-house investment rule that applies to superannuation schemes should be reduced from its current level of 10% to 5%.[36] In other jurisdictions there are restrictions or prohibitions on such in-house investment. For example, in the US there is a prohibition on certain transactions such as the aquisition of the sponsoring employer's securities[37] and in the UK self-investment is shortly to be restricted to 5% of the fund's assets.[38]

11.25. ***Submissions.*** There was general support among submissions for such a reduction. In the submissions generally there was a distinction drawn between arms length and non-arms length schemes (usually, smaller schemes). It was suggested that, in the latter case, a 5% limit might be too low. The Review has concluded that there are no compelling reasons for small schemes to be excused from such a requirement, especially in light of the Commonwealth's stated objective of securing retirement benefits.

36. DP 50 proposal 7.3. The Review notes that the Campbell Committee Report proposed that a fund be prohibited from investing greater than 5% in any single investment, not just in-house investments: para 20.125.
37. ERISA s 407.
38. ACTU *Submission* March 1992; TCA *Submission* February 1992; Australian Friendly Societies Association *Submission* February 1992; National Australia Bank *Submission* March 1992; Westpac Financial Services *Submission* February 1992. One exception was ASFA, which argued that it was premature to impose a tougher in-house test ASFA *Submission* March 1992.

11.26. ***Valuation.*** An in-house investment restriction could be expressed in terms of the cost or market value of scheme assets. Although conceptually correct, there are problems in using market value as the basis for this restriction. First, it requires that a market value be determined for all assets of a scheme. Such an exercise may be unduly costly. Secondly, market values could be subject to considerable fluctuations or changes (over time and between different market places) and arguably have greater potential for abuse. Accordingly, the Review accepts that the in-house asset restriction should be assessed on the basis of the historic cost of the assets of the scheme. The Review recommends that the 5% limit be applied to all schemes, whether or not there are arms-length members. To allow schemes an appropriate time to meet this requirement, it recommends that there be a lead time of three years beyond that currently applying to the 10% requirement.[39] The literature on in-house asset rules often assumes that there is only one employer sponsor. The Review considers that the same risks apply in the case of industry schemes. Accordingly, they should be subject to a similar restriction, namely that no more than 5% of the scheme be invested in the employers whose employees are members of the scheme.

Recommendation 11.4: In-house investments

1. The law should provide that the responsible entity for a superannuation fund must not knowingly lend to, or make an investment in, an employer sponsor of the fund or an associate of the employer within the meaning of the Income Tax Assessment Act of an employer sponsor of the fund if the amount of the loan and the value of the investment (worked out at cost in the prescribed way) is more than the prescribed percentage of the total of the value of the assets of the scheme.

2. The law should provide that the responsible entity of an industry fund must not knowingly lend to, or make an investment in, 2 or more of the employer sponsors of the fund or in an associate of such an employer within the meaning of the Income Tax Assessment Act if the total amount of the loans and value of the investments is more than the prescribed percentage of the total of the value of the assets of the scheme.

3. Contravention of this provision should be an offence on the part of the responsible entity.

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39. Schemes established before 11 March 1985 have until 1 July 1995 before they have to comply fully with this requirement: OSS Regulations reg 16A(17)(b).

4. Values should be worked out as provided in OSS Regulations reg 16A.

5. The prescribed percentage should be such that, by 30 June 1998, it is 5%.

Borrowing by superannuation schemes

11.27. The OSS Regulations restriction on borrowing by superannuation schemes[40] goes hand in hand with the requirement that members' benefits be fully secured[41] and is designed to protect the scheme's assets. There was overwhelming support among the submissions for such a control.[42] The Review does not recommend any fundamental change to the current position in relation to superannuation schemes and ADFs.[43] The Review considers that the restriction on borrowing should apply to PSTs. They are comprised 100% of superannuation funds and, therefore, should be subject to the same controls as superannuation schemes.[44] If this were not the case, the restriction on borrowing by superannuation schemes could be overcome by investing in PSTs.

Recommendation 11.5: Borrowing by superannuation funds etc.
1. The law should provide that the responsible entity for a superannuation fund or an ADF must not borrow, or maintain a borrowing of, money, whether on security or not. Non-compliance should be an offence. There should be a defence that the borrowing was temporary and made only to enable the scheme or ADF to pay benefits due to its members.

2. The law should provide that the responsible entity for a PST must not borrow, or maintain a borrowing of, money. Failure to comply should be an offence. There should be a defence that the borrowing was temporary and made only to enable the PST to meet its buy-back obligations.

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40. OSS Regulations reg 16(1)(b).
41. OSS Regulations reg 5AB(2)(b).
42. eg Office of Queensland Cabinet *Submission* March 1992; National Australia Bank *Submission* March 1992; Securities Institute of Australia *Submission* February 1992; BT Asset Management *Submission* February 1992; Mercer Campbell Cook and Knight *Submission* February 1992; AMP Society *Submission* February 1992; National Mutual *Submission* February 1992.
43. The Review notes that the international trading in securities by superannuation schemes, ADFs and PSTs may result in a scheme being unintentionally temporarily geared because of the failure of the transaction to be settled before the transfer of the securities the subject of the transaction takes place. This issue should be addressed.
44. See recommendation 11.3.

Use of futures and derivatives

11.28. ***Proposal.*** At present, there are no specific restrictions on the use of futures contracts or derivative instruments by superannuation schemes.[45] While the Review recognises that derivatives and futures can represent a legitimate and efficient aspect of a scheme's investment management, it is concerned about the possible speculative use of such instruments. DP 50 proposed that the speculative use of futures and derivatives (as opposed to their use for hedging purposes) be prohibited.[46] This received strong support in submissions.[47] However, concerns were noted regarding the definition of the term 'speculative'.[48]

11.29. ***Recommendation.*** After consultation on this matter, the Review has refined the wording of the proposal and recommends that the use of futures, options and derivative instruments should be prohibited unless used for hedging purposes, for risk management, for duration management of fixed interest portfolios or as a substitute for the outright purchase of other assets. The Review is also of the opinion that futures should not be used in such a way as to cause the scheme to be geared. In particular, 'uncovered' writing of futures and call options should not be permitted. The complexity and difficulty of adequately defining gearing in this context are, however, immense. The Review recommends, therefore, that the Government, in consultation with relevant industry bodies, should investigate an appropriate terminology and standard so as to be able, in the longer term, to prohibit the use of futures, options and derivative instruments for gearing purposes.

Recommendation 11.6: Use of futures etc.

1. The law should provide that the responsible entity for a superannuation fund, an ADF or a PST must not invest in a futures contract or a derivative instrument except

- **for hedging purposes or**
- **for risk management or**

45. The Treasurer proposed that 'an outline of any futures options or other derivative mechanism strategies relevant to fund or sub-plan assets' be included in the annual report to members. Treasurer's statement, paper 2 para 10(e)(ii).
46. DP 50 proposal 7.5.
47. Jacques Martin Industry *Submission* February 1992; Westpac Financial Services *Submission* February 1992; Women's Economic Think Tank *Submission* February 1992; ASFA *Submission* March 1992; D Knox *Submission* February 1992; Department of Finance *Submission* February 1992; National Australia Bank *Submission* March 1992.
48. eg Australian Securities Commission *Submission* March 1992; Securities Institute of Australia *Submission* February 1992.

- **for duration management of fixed interest portfolios or**
- **as a substitute for the outright purchase of other assets.**

Failure to comply should be an offence.

2. The law should provide that, if, because of an investment in a futures contract or a derivative instrument, the fund, ADF or PST becomes geared, the responsible entity is guilty of an offence.

Liquidity requirements for superannuation schemes

11.30. ***Annual certification as to solvency.*** In view of the strict controls on borrowing by superannuation schemes, responsible entities need to ensure that their expected liabilities can be met from the realisable assets of the scheme without unnecessary recourse to borrowing. Indeed, the Review considers this to be so important an obligation on responsible entities that it recommends that the obligation be included in legislation. The Review sees merit in requiring the responsible entity to report annually to the regulator on whether the expected liabilities for the next year can be met as they fall due without recourse to borrowing. Where necessary the regulator can take appropriate action, which may include enforcing a higher level of liquidity. This annual notice to the regulator should also include information about what happened in the previous year as regards the scheme meeting its liabilities and any recourse to borrowing.

Recommendation 11.7: Certifying solvency

The law should provide that the responsible entity for a superannuation scheme, an ADF or a PST must, within 2 months after the beginning of a financial year, certify in writing to the regulator whether the expected liabilities of the fund, ADF or PST for that year can be met as they fall due without recourse to borrowing. Non-compliance should be an offence.

11.31. ***Matching requirement for personal schemes and ADFs.*** Because amounts held in personal schemes are transferable at the election of scheme members, it is further recommended by the Review that the responsible entities of personal schemes should be required to ensure that the portfolio of assets held by the scheme is appropriate (in terms of realisability) to the scheme's redemption period.[49] For example, schemes that have longer redemption periods could

49. The suggestion that schemes be required to match their redemption period and the underlying liquidity of their assets was made in DP 50 para 7.23. There was a paucity of written responses on this paragraph.

hold a higher proportion of illiquid assets. An ADF's redemption period is set in its deed. For taxation purposes, however, the deed must comply with the ITAA, in particular, the provision that the fund must repay depositors 'upon request'.[50] There is a similar provision in OSSA.[51] The Review understands that the ISC has generally viewed 'upon request' to mean within 30 days.[52] The Review is aware that, during the property boom, some ADFs invested up to 80% of their funds in property trusts. When the property market collapsed and property trusts froze redemptions, those ADFs were unable to meet their own redemption obligations. The Review considered prescribing a longer redemption period for ADFs that invest more than a prescribed proportion of their funds in property or in property trusts, but has decided against such a recommendation. Instead, the Review recommends that all ADFs be formally required to match their assets to meet their redemption periods.[53]

Recommendation 11.8: Redemption periods for personal schemes
The law should provide that personal schemes must have assets appropriate to their redemption periods. No specific sanction is required as the question is dealt with under recommendation 9.2.

Emergency liquidity support

11.32. DP 50 called for comments on the desirability of a mutual emergency liquidity support mechanism, as an alternative to a prescribed liquidity ratio.[54] Under such a regime each scheme would be required to keep a prescribed level of liquid assets which the regulator could direct it to liquidate and lend to another scheme facing temporary liquidity problems. This matter drew little response. Those that did comment suggested that such an arrangement should not be introduced.[55] Accordingly, the Review has not proceeded further with this idea.

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50. ITAA s 27(A)(1)(c).
51. OSSA s 3(1), definition of 'approved deposit fund' and 'approved purposes'.
52. Although the OSS Regulations reg 20 provides that depositors must receive their entitlements on their 65th birthday or, in the event of death, 90 days from the grant of probate.
53. It is to be hoped that by formally requiring this matching, the irresponsible investment strategies pursued by some ADFs recently will not be repeated, as a failure to properly match investments will be actionable by scheme members as a breach of the ADF's statutory fiduciary duties.
54. DP 50 para 7.22.
55. For example, the ASC stated that such a scheme would involve financially successful funds providing loans to funds in financial difficulty on a non-commercial basis. It argued that this would be contrary to the best interests of the members of the financially-successful fund: ASC *Submission* March 1992.

Liquidity requirement for PSTs

11.33. PSTs, like most other collective investments, may also be subject to mass unexpected withdrawals. The PST's buy back period will, to a large extent, determine whether any difficulties are experienced. The increasing sophistication of trustees may mean they will begin to more often move funds. DP 50 raised the issue whether it is appropriate that in these circumstances a minimum liquidity requirement should be imposed. Although submissions did not seem to comment directly on this issue, in the light of comments received on the proposal to impose prescribed liquidity standards on superannuation schemes and the Review's recommendation that PSTs be subject to the same kind of investment and gearing controls as superannuation schemes,[56] it is of the view that there is no need to prescribe a minimum liquidity standard for PSTs.

56. Recommendation 11.3.