



24 December 2020

Manager  
Retirement Income Policy Division  
Treasury  
Langton Cres  
Parkes ACT 2600

superannuation@treasury.gov.au.

## Submission: Your Future, Your Super package

The Centre for Law, Markets and Regulation (CLMR) is a premier research centre for the study of the dynamics of market regulation. The CLMR is a joint initiative of the Faculty of Law and the UNSW Business School. Centre members produce high quality research on the legal, regulatory and contextual aspects of markets, corporations, finance and business transactions. The Centre's work is distinctive in the range of market institutions it studies, and its focus on understanding the nature and effects of regulation. The work is also distinctive because while in a commercial context, the CLMR's research often has social justice aspects. The CLMR uses good ideas derived from research to have influence and impact with regulators and government, fellow academics, corporations, financial and business entities and the wider community. We offer the following response to the consultation questions.

The authors have over 70 years of experience of investment markets in three continents and in a variety of roles from analyst to committee membership.

Yours faithfully

M. Scott Donald  
Director, Associate Professor

Anthony Asher  
Adjunct Associate Professor

# 1 An appeal to fundamental norms

The Hayne Royal Commission highlighted the desirability of parliament identifying the fundamental norms of behaviour expected from legislative initiatives such as this one. It said:

***Recommendation 7.4 – Fundamental norms***

*As far as possible, legislation governing financial services entities should identify expressly what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter.*

In our opinion, the proposed legislation does not always adequately address the fundamental norms with sufficient clarity, and thus may not fully achieve its aims and will have unintended consequences. We also suggest that the legislation could achieve its aims more efficiently if it were shorter and more simply structured.

## 2 Analysis of the reforms

### 2.1 Best “financial” interest

We would suggest that the underlying infringement of the fiduciary norm which this aspect of the legislation is intended to address is the potential for trustees to abuse their powers for collateral, and potentially partisan, purposes. In particular, there are questions around political donations, the funding of partisan media and the incorporation of environmental, social and governance (ESG) issues into investment decisions. If this is the intention of the legislation, we would suggest that this is explicitly included.

The best financial interests duty reform contains two components whose impact, we believe, are likely to be overestimated:

- The insertion of ‘financial’ into the covenants in the section 52(2)(c) and 52A(2)(c) of the *SIS Act*. We believe this amendment will be of little substantive effect because the courts have traditionally interpreted those covenants as including implicitly that qualification.<sup>1</sup> It will therefore not constrain trustees’ adoption of ESG and impact investing approaches.<sup>2</sup> It will also not, of itself, change the ability of superannuation fund trustees to expend fund assets on marketing and advocacy activities, although we note that APRA’s attention to such matters appears to be increasing.<sup>3</sup> This not to say that the amendment is purely cosmetic; the function of this component of the reform appears to be in signalling to a lay audience more accurately what is required of superannuation fund trustees and their directors.

---

<sup>1</sup> *Commonwealth Bank Officers Superannuation Corporation v Beck* (2016) 334 ALR 692; *Australian Prudential Regulatory Authority v Kelaher* (2019) 138 ACSR 459.

<sup>2</sup> See M. Scott Donald and Nicholas Taylor, ‘Does “sustainable” investing compromise the investment obligations owed by superannuation fund trustees?’ (2008) 36 *Australian Business Law Review* 47; M. Scott Donald, Jarrod Ormiston and Kylie Charlton, ‘The potential for superannuation funds to make investments with a social impact’ (2014) 32 *Companies and Securities Law Journal* 540.

<sup>3</sup> See for instance APRA *Prudential Standard SPS 515 Strategic Planning and Member Outcomes* (Dec 2019).

- The apparent reversal of the burden of proof in section 220A. In principle we believe such a reversal would be undesirable. There has been considerable growth in APRA and ASIC's powers of enquiry and investigation over the past decade. There is therefore no reason why the asymmetries of information that exist for a private citizen as a result of the opacity of the superannuation system should also constrain the regulators. That said, the provision is in essence a rebuttable presumption, rather than a true reversal of onus, so the substantive change brought about by the reform is less than it appears on the surface.

We do however perceive the potential for several unintended consequences:

- The introduction in section 117A of a list of prohibited transactions is new, but its impact can only be fully ascertained when the list is formulated in the Regulations. It seems likely that many of the transaction types that will appear on the list would already be inconsistent with the sole purpose test in section 62 of the *SIS Act* or beyond the power of superannuation trustees under the general law. The danger with lists such as that anticipated in section 117A is that they come to represent the extent of the law in the area, and items of expenditure that can be distinguished from those identified on the list are taken thereby to be authorised. This has the effect, implicitly, of transferring the regulatory risk from the trustee to parliament, in that a failure by parliament to include an unacceptable expenditure on the list can lead to its being deemed acceptable through an *eiusdem generis* process. Importantly, therefore, our reading of the provision suggests that those extant constraints on trustee expenditure will continue to apply and that the list will not be used to read down the content of the sole purpose test and general law. We hope that this perspective is maintained by APRA, in particular, because if it is not then this reform will have a seriously detrimental effect on the regulatory regime, encouraging superannuation fund trustees to use compliance with the list as sufficient.
- The legislation as currently drafted will prevent funds giving advice to their members that might lead to them working for lower incomes or reducing their investment risks because they believe that they have enough financial resources. This could be interpreted to not be in their *financial* best interests.

## 2.2 Single default account

In this case, we accept that the fundamental norm is adequately expressed and that the legislation should benefit members and reduce the number of unnecessary and unwanted accounts.

## 2.3 Right to remain test

In the case of investment underperformance, our submission is partly informed by government media releases and their indication of the nature the proposed regulations as well in the proposed s348B that specific formulae will be rigidly applied by the test.

The underlying norm with which this reform engages appears to be infringement of the crucial duty on the trustees of superannuation funds to make investment decisions in the best interest of the members. As it stands, we believe it will fail in its intended purpose. It will be both overinclusive (penalising funds whose future performance can reasonably be expected to be better than their past performance) and underinclusive (because it will fail to identify infringements of the fiduciary duty if the fund is not below the underperformance threshold). It will also have the unintended



consequence of imposing significant financial consequences on the funds and members of funds that find themselves below the threshold for good reasons. Section 2 of our appendix discusses these.

We are convinced that while an annual outcomes test is desirable, it will be too blunt an instrument unless it is applied with regard to the circumstances of the fund. Just as important, it must have regard for the realities involved in addressing the reasons for underperformance to ensure that those reasons do not persist into the future. Leaving it to members to exercise choice exposes disengaged members to significant risk and exposes all members to the risk of predatory behaviour that the anti-hawking provisions will not mitigate.

In addition, we submit that the government's proposal to implement the Productivity Commission's (PC) recommendation that superannuation fund trustees satisfy an ongoing investment performance test has a number of design flaws. We are aware that more comprehensive descriptions of the technical shortcomings of the tests have been made available to Treasury either in published form<sup>4</sup> or as part of the submission process. We choose here, therefore, to identify the main themes. In summary these are:

1. It is inconsistent with a fundamental tenet of the accountability regime applied to superannuation trusteeship. The covenants in section 52 of the *SIS Act* require the trustee to formulate and implement an investment strategy that is tailored to the trustee's assessment of the needs of the members of the fund. The proposed test takes account of the strategic asset allocation decided by the trustee to be most appropriate but does not otherwise capture the tailoring undertaken by the trustee across other dimensions of the strategy (such as the listed/unlisted split, the use of alternatives, hedging strategies, liquidity management and tactical asset allocation). This will result in capricious assessments of past performance (see retrospectivity below) and will distort trustee decision-making in undesirable ways going forward.
2. It applies retrospectively. Although it does not make unlawful conduct that was lawful at the time, it attaches new, adverse consequences to that conduct. More problematically, it penalises for a second time those members whose superannuation balances have already been subject to the underperformance. We submit that this is highly undesirable.
3. It misunderstands the randomness that is inherent in investment management. This deserves greater attention so we have included some preliminary discussion of this issue in an Appendix.

Finally, we note that all modern regulatory regimes applied to the financial services sector repeat some version of the mantra that 'past performance is not a reliable guide to future performance'. They do so for a reason. Understanding why performance came about is essential to understanding whether it is likely to persist. In that respect we are surprised that the performance test as currently formulated makes almost no use of performance attribution technologies.

We further note that the PC report recommends detailed performance attribution as "a must have for all trustees" (p. 444), and is somewhat disappointed that funds do not seem able to provide the information that would come from even simple attribution analyses. Their comment is worth repeating:

---

<sup>4</sup> See for instance M. Scott Donald, 'Addressing chronic underperformance in the superannuation system' (2020) 32(4&5) *Australian Superannuation Law Bulletin* 74.



*Ongoing performance attribution is critical to funds understanding and improving their performance. In substance, it is the ultimate outcomes test for a trustee board to ask and answer robustly — are we, over time, ‘adding value’ above and beyond a market index return? A trustee board ought to satisfy itself (to retain the right to continue to take contributions and be the trusted guardian for their members) not simply by processes and good intent, but in terms of delivered investment performance outcomes for members. Ideally, such attribution would be also assessed independently of the fund.*

We also note that APRA’s current Prudential Standards SPS 515 Strategic Planning and Member Outcomes and SPS 530 Investment Governance do not require funds to perform such analyses.

The failure of trustees to insist on adequate reporting, and of regulators to address the problem, does need explanation. In a two-year study of the culture and behaviour of nine large pension funds in the United States, O’Barr and Conley<sup>5</sup> confirm the author’s experience of ‘surprising and sometimes disturbing’ evidence of ‘an unsystematic approach’ to investment decisions. They observe that ‘relationships are often more important than managing the bottom line in evaluating and deciding whether to retain managers’. (p. 70) Trustees are normally unwilling to question investment managers in any detail being perhaps a little overawed by investment professionals and reluctant to undermine the relationship by asking for proper accounting. On the other hand, the investment managers have told us that there is no demand for more detailed reporting. Evidence of such failures can be obtained by the perusal of investment committee minutes, but they are seldom public.

This dominance of experts is described by academic John Kay as “intellectual capture”:

*Regulators come to see the industry through the eyes of market participants rather than the end users they exist to serve, because market participants are the only source of the detailed information and expertise this type of regulation requires.<sup>6</sup>*

For this reason, we welcome the Treasury’s involvement in the drafting of regulations in that they are more remote from industry, although we do note that no-one is entirely exempt from such capture. If the new regulations are to have their desired impact, we recommend that they require detailed audited annual attribution analysis.

---

<sup>5</sup> O’Barr, W.M. & Conley, J.M. *Fortune and folly: the wealth and power of institutional investing*. (1992, Business One, Irwin, Homewood, Illinois).

<sup>6</sup> <http://www.johnkay.com/2012/07/22/finance-needs-stewards-not-toll-collectors>

## Appendix: The extent of randomness

We are reluctant to criticise the PC report with its extensive analysis and its wide consultation over a lengthy period of time, but it seems to us that the PC report fails to adequately communicate the nature and extent of randomness in investment outcomes, and that its elevated annual outcomes test is not consistent with the results of its analysis. We do note that it is clear in the inadequacy of its analysis: “However, the analysis was not intended to be a classic performance attribution analysis (that would usually be conducted at an asset-class level). Rather, the intent was to look for factors that could explain differences in performance, using the available data.”(p.112)

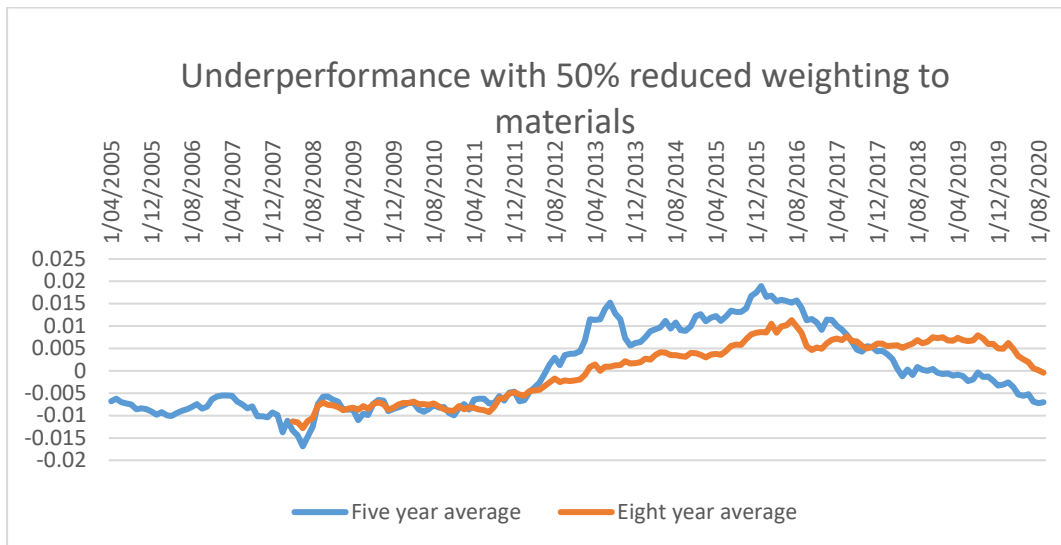
The PC report says – without any evidence that we are able to find: “The analysis is over the longest period permitted by the data, thus should mostly abstract from random variations,” (p. 22) and again: “Randomness (and risk) is dealt with by analysing performance over the long term.” (p.114) It starts with the implicit claim that its tests have dealt with randomness: “It is nigh impossible to overstate the significant implications for members’ retirement incomes from this wide dispersion in fund performance over the long term.” (p.10) But this is to fail to recognise that the causes of underperformance are excess costs and over-trading, but that for most funds relative performance is cyclical (over long periods) and that the long term is measured in decades – not only eight years. Mark Carhart<sup>7</sup> largely settled this question over 20 years ago. He found persistence in performance was restricted to poorer performers which charge or trade excessively, although further research has identified a role for some fund managers, and trading strategies.<sup>8</sup> Relative performance for the majority of funds may however persist for long periods (five to ten years) because of style “biases” that are not signs of poor management or inadequate concern for members.

As an illustration of randomness and its likely impact on performance, one can consider the relative performance of the ASX Materials index relative to the All Share index. This is relevant because foreign investors are more exposed to mining and materials than to other sectors because they are more attractive for diversification reasons. The sector is normally underweighted by local investors both because of its volatility and the entire economies exposure to mining makes it less attractive. The chart below shows the impact difference in the return on the ASX all shares and one with 50% of the weighting in the Materials sector. The data available were from 2000 so eight year averages are available from 2008. This means that funds that, from 2008 to end 2011, funds with 50% less exposure to Materials would have underperformed by more than .5% pa over an eight year average. On the other hand, from the end of 2015 to end 2019, funds with 50% less exposure to Materials. The ten year averages are shown to demonstrate that increasing the time period does not necessarily remove the problem because the economic cycles that can benefit one sector (or style) over another can extend over decades.

---

<sup>7</sup> Mark Carhart, ‘On persistence in mutual fund performance’ (1997) 52 *Journal of Finance* 57.

<sup>8</sup> Anand, A., Irvine, P., Puckett, A., & Venkataraman, K. ‘Performance of institutional trading desks: An analysis of persistence in trading costs’ (2012) 25 *Review of Financial Studies* 557.



We note that, while the PC report suggests benchmarking to a “portfolio of listed market indices” and that the explanation does seem to allow for tailoring the benchmark to the fund option.

*Benchmarking to a portfolio of indexes side-steps the need to benchmark choice options to comparable options in the market. And because a benchmark portfolio is tailored to (and thus agnostic of) the asset allocation of each option, it can be flexibly applied to a range of product types, including life-cycle products (p492)*

Our recommendation is that the Regulations permit funds to develop their own benchmarks. Even if these will effectively be retrospective initially, this deals with criticisms of the retrospectivity of the legislation, and will be prospectively determined for future outcome tests.