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18 December 2020

Mr Robert Jeremenko
First Assistant Secretary
Retirement Income Policy Division
Treasury
Langton Crescent
PARKES ACT 2600

**By email:** superannuation@treasury.gov.au

Dear Rob,

**Your Future, Your Super package**

CPA Australia represents the diverse interests of more than 166,000 members working in over a 100 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

The *Your Future, Your Super package* is a package of reforms which was announced in the 2020-21 Federal Budget. This consultation contains the following parts of the announcement:

- A requirement for superannuation trustees to act in the best financial interests of their members in matters related to expenditure, decision-making and investment
- The 'stapling' measure, aimed at ensuring that employees who already have a superannuation fund are not unnecessarily made a member of a new fund as a result of changing jobs
- The introduction of a new performance test to be undertaken by APRA in relation to MySuper products, and
- The introduction of criteria to form the basis for a new website ('YourSuper'), to be maintained by the ATO, which will allow Australians to compare superannuation products ranked by fees and investment returns, as well as assist with opening and consolidating superannuation accounts

CPA Australia believes that some fine tuning needs to be conducted at a policy level to make these reforms fit for the purpose intended.

We make the following recommendations:

- CPA Australia does not support the proposed duty for trustees to act in members' best financial interests and recommends that Treasury not proceed with this proposal. This proposed duty is a subset of the existing best interests duty and is aimed to apply to decisions made which involve third party payments only. The existing best interests duty applies to all decisions made by a trustee

- The reversal of the evidential burden of proof in relation to meeting the best financial interests duty should not proceed for a number of reasons, including a lack of a materiality threshold, the increase to fund members in legal, risk and compliance costs, a high incidence of false negatives due to survivor bias, and costs of hindsight

- The proposed restriction of the best financial interests duty to third party payments is both inappropriate and not consistent with the policy, and if it was to proceed it should be extended to related party payments

- Commentary should be included in the Explanatory Memorandum to clarify future implications from the non-financial parts of the current best interests duty which will no longer be statutory requirements

- The proposed ability for record-keeping requirements to be set by regulations lack sufficient detail and should not proceed until more certainty about this proposal is known

- CPA Australia supports the single default account measure

- A period longer than two years should be chosen for MySuper products, taking into account the recommended minimum investment time horizon of the product. This should be tailored to additional products upon introduction into the performance testing regime

- Consultation on regulations should be commenced immediately to ensure performance testing of choice products can begin on 1 July 2022 and not later

- In exceptional circumstances, members of a superannuation fund should be allowed to access investment options which are closed to new member investment, subject to certain conditions

- The proposed YourSuper site should be developed and available to all ahead of the first failure notice, as well as appropriate planning to ensure that members who are notified are able to take appropriate action

CPA Australia welcomes the focus in this package on transparency and accountability. We note however, that existing transparency projects have not yet been completed. This suggests that a higher priority must be given to the product dashboard and portfolio holdings disclosure projects to make these available to superannuation fund members as soon as possible. Ideally, these tools should be in place prior to APRA issuing the first failure notice. Our feedback is contained within the attachment to this letter.

We acknowledge the valuable contribution to this submission by members of CPA Australia's Retirement Savings Centre of Excellence.

If you have any queries on this submission, please do not hesitate to contact Richard Webb, Policy Advisor Financial Planning and Superannuation on [redacted] or [redacted].

Yours sincerely

**Dr Gary Pflugrath CPA**
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**CPA Australia**

# Response to consultation

## Best financial interests duty

The Exposure Draft *Treasury Laws Amendment (Measures for a later sitting) Bill 2020: Best Financial Interests Duty* (referred to in this section as the 'Exposure Draft', the 'Draft legislation' or ED) presents measures to implement the new duty for trustees to act in the best financial interests of members. The duty will replace the current statutory duty to act in the best interests of members.

CPA Australia opposes this measure for the reasons discussed below. We support efforts to increase the transparency of and accountability by trustees, and applaud the Government's commitment to these objectives. However, it is important to note that the duty to act in members' best financial interests is not a higher hurdle, but rather, a subset of the existing members' best interests duty - raising the question of why such an existing far-reaching duty might be stripped back to a singular minimum.

In addition, where the current best interests duty applies to all fund activity and decisions, the scope of the proposed best financial interest duty is reduced in application to third party payments only.

The implementation of this new measure includes a specific reversal of the evidential burden of proof and is not subject to a materiality threshold. What this means is that a decision of any magnitude can be queried by the relevant regulator, requiring trustees to produce evidence on all occasions that trustees have acted in the best interests of members. The lack of a materiality threshold means that, hypothetically, as little as a few cents of funds invested on behalf of members could be pursued by regulators, leading to costly legal expenses that could potentially be incurred simply to defend a breach of very small magnitude. With the lack of a materiality threshold, a letter sent in error could be such an example where a few cents of postage causes a technical breach.

This suggests that any trustee's decisions which potentially give rise to actions will need to be thoroughly documented. This reversal of the burden of proof provides a disincentive to regulators to engage in due diligence when investigating a complaint. This may in turn result in an increase in the number of complaints put to trustees by regulators, together with an increase in resources dedicated to proving that the trustees did, in fact, act in the best interests of members. Such an increase in compliance and risk activity can only be borne by members, and as such, it is arguable that this policy may itself not be in members' best financial interests.

An additional problem which arises is the issue of survivor bias in relation to certain decisions made in the best financial interests of members. The business of wealth management, of which superannuation is a part, involves investment managers taking calculated investment risks on behalf of their members. Although great lengths can be gone to, to manage investment and other risks, it is risk that is assumed to pursue greater investment returns. Some funds will succeed, and other funds will not. It is likely that regulatory scrutiny will follow funds which do not provide returns commensurate with the level of investment risk which they have taken on. This means that in all likelihood there will be scenarios where a fund which has underperformed - but may in all ways be able to show that it acted in members' best financial interests - will be subject to more regulatory scrutiny than funds which outperform, whether or not they have acted in the best financial interests of members.

We are concerned that, with the benefit of hindsight, a decision may be made by a regulator to pursue an action against a trustee in relation to a payment, which at the time may have seemed quite reasonable, but at that point in the future appears to be less so.

Therefore, CPA Australia does not support the reversal of the evidential burden of proof and recommends its removal.

CPA Australia is particularly concerned with the operation of this measure in relation to third parties. The proposed insertion of subsections 52(3A) and 52B(2A) into the *Superannuation Industry (Supervision) Act 1993* is explained in the Explanatory Memorandum at paragraph 1.42 as:

> *As with the existing best interests duty, the new best financial interests duty will continue to apply to an exercise of a trustee's powers in making payments to third parties by, or on behalf of the entity or fund.* ***The amendments specifically clarify this as third party payments tend to be particularly subject to abuse.*** *These actions by a trustee must be in the best financial interests of beneficiaries. The trustee should be able to produce evidence supporting its decision, and have oversight that monies paid are being used by third parties for the intended purpose.*

(Our emphasis)

The sentence highlighted in bold is an extraordinary statement which appears to be at odds with history. In the Final Report to the *Royal Commission Into Misconduct In The Banking, Superannuation And Financial Services Industry*, Hayne (2019:327-329) writes about the case study related to AMP Life Limited, the entity within the AMP Group which was engaged by many of the group's funds as its insurer. The Royal Commission heard testimony from a senior executive at AMP that it was the role of AMP Life, as the administrator of many of AMP's superannuation funds, to undertake tasks involved with the selection of funds' life insurers, for which AMP Life was normally selected.

Concerns associated with conflicts of interest of this nature prompted Hayne to make Recommendation 4.14, which the Government supported regarding related party engagements:

> ***Recommendation 4.14 — Additional scrutiny for related party engagements***
>
> *APRA should amend Prudential Standard SPS 250 to require RSE licensees that engage a related party to provide group life insurance, or who enter into a contract, arrangement or understanding with a life insurer by which the insurer is given a priority or privilege in connection with the provision of life insurance, to obtain and provide to APRA within a fixed time, independent certification that the arrangements and policies entered into are in the best interests of members and otherwise satisfy legal and regulatory requirements.*

Although he restricted the commentary in this recommendation to discussion of group life insurance, Hayne discussed outsourcing to related parties elsewhere in the report, and noted on several occasions that this required just as much care and diligence on the part of trustees as outsourcing to third parties. For example, at Hayne (2019:231) in discussion of administration and management:

> *Outsourcing of the trustee's day-to-day administration and management of a fund to a related entity, or indeed, any third party, requires ongoing care and diligence on the part of a trustee. Where it is relying on information provided by the related entity, it must test the information it receives and seek further information where necessary. The trustee must satisfy itself that the trust is being run in the best interests of the members. The case studies showed that trustees are not always discharging this responsibility and regulators have not acted on this.*

Hayne (2019:232) goes on to note specific concerns in relation to outsourcing to related parties.

> *It should be remembered that Prudential Standard SPS 231 provides that an RSE licensee who outsources a material business activity to a related party 'must be able to demonstrate that the arrangement is conducted on an arm's length basis and in the best interests of beneficiaries'. The case studies suggest that, to date, this obligation has not led to sufficient rigour in the selection and monitoring of related party service providers. As later explained in the chapter on insurance, I recommend additional scrutiny for related-party engagements.*

It is of some interest then, that Hayne writes (2019:235), after considering payments made to third parties by industry superannuation funds:

> *I consider that the existing rules, especially the best interests covenant and the sole purpose test, set the necessary standards. Those standards should be applied according to their terms and without more specific elaboration.*

(emphasis removed for clarity)

Hayne felt strongly enough to assert that the best interests test not be adjusted. That is, changes to the test were not amongst the numbered recommendations. Also, throughout the report clearly Hayne felt that, whether outsourcing was to related parties or to third parties, trustees needed to apply similar levels of scrutiny.

The Productivity Commission (2018:26) noted what the case studies from the Royal Commission, then in progress, were revealing and stated that:

> *The Royal Commission has revealed evidence of conflicts of interest directly resulting in member harm, including many instances where trustees in vertically integrated retail groups have preferred the financial interests of related-party shareholders over those of their members.*

The Productivity Commission (2018:26) then went on to note APRA's concerns that "some funds may not be achieving value for money in their outsourcing arrangements" and that although the Commission's data was of poor quality, it suggested that funds which outsource administration to related parties pay more than those who outsource to an independent provider.

Historical examples of this abound, and not just in relation to group life insurance, administration or management. In 2016 for example, the Australian Securities and Investments Commission (ASIC) (2016) announced that ING Bank would be compensating members of its ING Direct Superannuation Fund (Living Super) product $5.4 million. The compensation came about after ASIC noted that the product - which was advertised as not charging fees - was receiving less in interest on the fund's cash holdings from its own bank, than what that bank was paying to retail depositors. ING Bank was alleged to have not disclosed this interest rate differential.

The issue of payments to related parties providing poor value to trustees has been of particular interest to APRA for some time. Liu and Arnold, in research commissioned by APRA in 2012, found that '[where] the trust deed establishing the superannuation fund required the trustee to use a related insurance provider… [w]e find that members of these funds purchase more insurance, and that their coverage is in the form of higher-cost products.' It is worth noting that Liu and Arnold found in previous research for APRA in 2010 that the effect of for-profit entities using related parties was that they tended to underperform, whereas not-for-profit entities which used related party entities did not generally pay more than independent providers.

As recently as 2015, APRA (2015 and 2015a) warned that trustees with related party arrangements needed to improve practices in relation to conflicts management and insurance in superannuation. More recently, Liu and Ooi found in 2018 that, for-profit funds significantly underperform when using related party service providers.

We note the policy intention of this measure as stated in the ministerial announcement (Frydenberg and Hume 2020):

> *the Government will increase trustee accountability by strengthening their obligations to ensure trustees only act in the best financial interests of members.*

Importantly, in addition to the ministerial announcement above, there was no mention of restricting this to third party payments in either the relevant section of the Budget papers (Commonwealth of Australia 2020:164) or the *Your Super Your Future* fact sheet (Treasury 2020:3). The apparent targeting of certain payments, but not others, could be considered to act against the diversity of the superannuation sector, where there are different benefits and features of superannuation offerings in Australia. The restriction to third party payments means that trustees of industry, corporate, public sector funds and self-managed superannuation funds will be largely required to demonstrate that their actions are consistent with members' best financial interests. However, retail funds making related party payments will effectively be exempt. It is therefore arguable that this measure has the effect of reducing trustee accountability for a little under a quarter of the total funds under management across the sector.

We recommend that restricting the scope of this measure to payments to third parties is inappropriate and should be removed from the Exposure Draft.

Elsewhere, we note that the removal of the requirement for trustees to act in the best interests of their members may have uncertain outcomes in relation to decisions made by trustees which have no likely financial outcomes. A trustee, for example, may be presented with a binary choice between two actions that have no known financial effects on members at the time of making the decision. However, one of the choices may benefit members in a non-financial way and therefore fall outside this duty as explained at paragraph 1.27 of the Explanatory Memorandum. While we believe that such a decision may be subject to a common law duty which exists in trust law, the Explanatory Memorandum may benefit from discussion of such a scenario. Such discussion should include the remedies available to affected parties, and whether this will be within the jurisdiction of regulators and/or complaints bodies to pursue.

An additional problem is the interaction between the proposals and the Non-Arm's Length Income (NALI) requirements for self-managed superannuation fund (SMSF) trustees. Indemnifying trustees (and directors of corporate trustees) for normal fund expenses is common across all types of trusts, including APRA-regulated funds. An SMSF which is unable to obtain evidence that a payment to a trustee (or director) is in members' best financial interests may decide not to indemnify that expense. It is possible that a trustee or director who is unable to be indemnified may instead cause the fund to breach the NALI provisions. This would be an unacceptable outcome.

A final observation is in relation to record-keeping requirements. The proposed paragraph 34AA makes it an offence to breach the regulations in relation to record-keeping standards which can be set by the regulations. It is not clear from the Exposure Draft what is likely to be proposed, and we note that this comes on top of the requirements needed to satisfy the reversed evidential burden to show that a trustee acted in the best financial interests of members. It is possible that this combined weight of documentation requirements may be too onerous for trustees of SMSFs. Therefore, we believe that this provision should not proceed in its current form until there is more certainty as to what is being proposed.

## Single default account

The Exposure Draft *Treasury Laws Amendment (Measures for a later sitting) Bill 2020: Single default account* (referred to in this section as the 'Exposure Draft', the 'Draft legislation' or ED) presents measures to introduce the notion of a 'stapled' fund, for which an employer can satisfy the choice of fund requirements for new employees by contributing to this stapled fund on their behalf. A stapled fund is to be defined in the regulations but is normally intended to be the active superannuation account to which an employee's contributions have been forwarded in the period prior to commencing with the new employer.

Regulations will be introduced which are intended to resolve uncertainty in instances such as the ability of funds to accept contributions, multiple active funds and where employees choose a new stapled fund.

The presence of a stapled fund is intended to form a 'first default' in the instance that an employee does not choose a superannuation fund. Given that funds chosen presently by employees exercising their rights to choose a fund are likely to favour an existing active fund account, this will reduce the paperwork on new employees at a time when they would prefer to start work in their new roles. The role of an employer's default fund thus becomes a second default in the event that a new employee does not choose a fund and does not have a stapled fund.

CPA Australia supports this measure, as it will reduce the prevalence of Australians holding multiple superannuation accounts, meaning that they will be better able to organise their retirement savings affairs.

## Underperformance

The Exposure Draft *Treasury Laws Amendment (Measures for a later sitting) Bill 2020: Addressing underperformance in superannuation* (referred to in this section as the 'Exposure Draft', the 'Draft legislation' or ED) introduces the annual performance test for MySuper products, to be undertaken by APRA. Trustees who fail the annual performance test will be required to notify members in that product. In the instance that a product fails the performance test in two consecutive years, trustees will be unable to accept new members into that product, until such a point that APRA is satisfied that the prohibition should be lifted.

The regulations will specify circumstances which must be satisfied in order for APRA to lift the prohibition. Future regulations will prescribe other products to be included in the testing. APRA will also be provided with prudential standard making power in relation to resolution making.

CPA Australia welcomes the focus on ensuring that funds are accountable and transparent. However, we believe that this provision requires considerably more work before it would be of any benefit to fund members.

The most obvious issue with the proposal is the short-term nature of the measurement. Trustees of MySuper products with a single stage generally recommend a minimum time horizon of between three to five years for investment in the product, with some trustees recommending seven or more. Yet, this proposal seeks to have a MySuper product excluded from accepting new investments from members after only two years of underperformance. Given that the audience for MySuper funds is predominantly disengaged members who may not have great confidence in managing their own investment affairs, this potentially sends out a message which may be inconsistent with the need to view one's investment through a longer time horizon. Arguably, the need to send notices to members after failing the performance test after a single year is inconsistent with the message "past performance is not a reliable indicator of future performance" or similar, which superannuation funds routinely display on disclosure documentation and elsewhere.

Additionally, we note that the two-year period may not only provoke short-term thinking amongst members, but also from trustees. It has long been the general consensus that in active investment management, growth styles generally outperform after a downturn when the market is bullish, whereas value styles tend to outperform during bear markets. Where trustees have chosen a variety of investment managers, these have typically been intended to be of complementary investment management styles. It is reasonable to expect that trustees may move between investment managers more frequently. In turn, this increased movement between investment managers may increase costs to members.

The proposed underperformance test echoes, in part, Recommendation 4 of the Productivity Commission (2018) final report. However, the recommendation of the Productivity Commission was considerably more specific than this proposed measure and recommended that the ideal period for rating how effectively a fund met benchmarking was a rolling eight-year period. In this instance, we agree with the timeframe preferred by the Productivity Commission, and recommend that a longer period be chosen, appropriate to the recommended minimum time horizon for the product.

Where MySuper products have multiple stages in the form of a 'glidepath', where the asset allocation is progressively tilted more in favour of generally defensive assets and away from longer term assets as members age, the question inevitably arises, 'which stage of the glidepath is being rated'? Also, what happens to members who are due to go into the next stage of a glidepath, if that stage is subject to prohibition?

APRA-regulated superannuation funds cater to a variety of members. As explained above, the recommended minimum time horizon for a MySuper product may be inappropriate for a member who might be nearing retirement, or for whom a fund's exposure to longer term investment assets may not reflect their personal exposure to investment risk. For some members, a variety of additional investment options are made available in the form of choice products. It is possible that a fund's more defensive options may be more appropriate. However, this raises another issue with this measure: Choice products - the investment options at an APRA-regulated fund which are not the MySuper option - are not included in this measure.

Although we welcome the announcement (Frydenberg and Hume 2020:3) that choice products will eventually be included in underperformance testing by 1 July 2022, we note that the recommendation from the Productivity Commission was that there be no more than a six month delay between testing MySuper products, and testing choice products. This draft legislation proposes a delay of a year, and as proposed, regulations will prescribe other classes (investment options) to be included in performance testing.

Without any currently scheduled consultation in relation to the other products proposed to be included, we are concerned that this transparency measure is likely to be delayed in the same way that current policy in relation to product dashboards and portfolio holdings disclosure has been held up. ASIC has developed requirements for funds to provide consumers with product dashboards - information on the performance and costs of choice products in a simple format - as well as to disclose funds' total portfolio holdings. These were both scheduled to apply from 2017 but the application date was recently extended due to the need for regulations to be made to give effect to these. The parallel in this case is that MySuper product dashboards are in effect and in use by funds with MySuper products, whereas choice product dashboards are still under development.

We recommend that consultation on regulations be commenced immediately to ensure performance testing of choice products can begin on 1 July 2022 and no later.

We further recommend that a higher priority be given to the product dashboard and portfolio holdings disclosure projects to ensure that these valuable tools can be made available to superannuation fund members as soon as possible - noting that the Productivity Commission recommended choice product dashboards be made available by the end of 2019.

CPA Australia is also concerned about how this measure is proposed to be implemented. The intended operation of this measure will see a MySuper option precluded from accepting new members if the product has failed the underperformance testing for two consecutive years. The prohibition will have effect whether a member is switching into the investment option, or for new members joining the fund who are enrolled in the product by default. This may have some problematic outcomes, particularly in the future when all of a fund's investment options are subject to the performance testing.

An example of a problematic outcome may be a member who has been recommended to hold a particular portfolio of assets, but in order to do this a small part of the member's account needs to be switched into one of the fund's investment options, which has failed performance testing for two consecutive years, and is thus prohibited from accepting new members. Assuming that none of the fund's other investment options have been similarly prohibited, what then? If this is for a small part of the member's portfolio, this may actually require the member to move part of his or her superannuation monies to another fund. Given costs involved in moving money between funds, such as buy/sell spreads as well as duplicate dollar-based costs such as administration fees, it may have been in the member's best financial interests to have invested in the closed underperforming product, rather than opening a new account elsewhere to access a performing equivalent product.

This is a strange outcome, and we note that the more investment options a fund has, statistically the more likely it is that a fund will, at any given point in time, have investment options subject to prohibition. We recommend that in exceptional circumstances such as these, members of a superannuation fund should be allowed to access prohibited investment options, provided that they are made fully aware of the risks involved in accessing that product.

Finally, we noted earlier that the decision to commence this measure with MySuper products and not choice products may incur problems, unless implementation is accompanied by assistance for disengaged members of superannuation funds. This raises several questions after a fund records a failure event, as a result of the underperformance test:

- Are disengaged members likely to be engaged enough to read the failure notice?
- What if they decide to exercise choice of fund - will the proposed YourSuper site (Frydenberg and Hume 2020:1) be up and running in time to assist the first of these members in choosing a new fund?
- Will the available fund choice on YourSuper be limited to the 100 or so MySuper products (not counting products under prohibition) or will the additional 44,000 choice products (Mather 2019, citing APRA Deputy Chair Helen Rowell) be available by then?
- Will financial advice be made available to affected members to assist them with choice?
- Is there a plan in relation to liquidity risk in the instance that a critical mass of engaged fund members decides to leave both the product and the fund at once?

We recommend that the YourSuper site be developed and available to all ahead of the first failure notice. We similarly recommend that Treasury, as a priority, consults with all stakeholders to ensure that a plan is developed for a failure notice which could potentially affect millions of superannuation fund accounts. This is likely to be the next large test of Australia's $3 trillion superannuation sector.

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