14 October 2022

Director
Superannuation, Efficiency and Performance Unit
Treasury

By email to YFYS@treasury.gov.au

Dear Director

Thank you for the opportunity to provide a submission to the Commonwealth Treasury on the *Your Future, Your Super* measures introduced in 2021.

Preliminary

By way of introduction, I am an Associate Professor at UNSW Sydney in the Faculty of Law and Justice. I research in the areas of trust law, superannuation, managed investments and the regulation of financial markets. My PhD was on the role of trust law in the regulation of Australian superannuation funds. I am also retained on a part-time basis as an External Consultant by Herbert Smith Freehills.

Prior to entering academia in 2010, I worked for ipac (1986-1994) and Frank Russell Company (now Russell Investment Group) (1994-2009, including five years as Director of Research and four as Director of Product Development). Much of that time was spent actively involved in advising superannuation funds and their stakeholders on governance matters and in investment manager research and selection. In two of the three calendar years that I managed Russell's investment research team in Australia it was ranked first in the country for funds manager research by Greenwich Associates (it was ranked second in the other year).

The views expressed in this submission are informed by my experience and research, but they are my own and ought not be taken to reflect the views of UNSW Sydney or Herbert Smith Freehills, nor any of their clients, employees or associates. I make this submission in my personal capacity and not on anyone's behalf or at anyone's instruction.

Submission

I wish to make submissions specifically in respect of some, but not all, of the questions posed in the Consultation Paper.

1.	Does the measurement of actual return using strategic asset allocation affect risk-taking behaviour by superannuation trustees?

Anecdotal evidence suggests that this has occurred, but I note that that is partly the point of the test. The prospect that the design of the annual performance test would reduce the risk tolerance for the tracking error caused by active management, investment in unlisted assets and off-

benchmark investing in favour of the risk tolerance for benchmark risk (ie a more risky SAA) was well known when the test was initially proposed.

It is also worth noting that the annual performance test currently embodies an approach to the design of an investment strategy (the concept of an SAA) that is by no means the only viable approach. The approach was designed not on the basis of academic research but rather was developed by US investment consultants in the late 1980s as a means of governing and measuring the investment decisions in a convenient and tractable way. (Close attention to the literature in the area will identify that the publication of articles using the approach in the middle years of the 1980s has subsequently been used as evidence of the approach's academic credentials).[1] Importantly in the current context, the imposition of an annual performance test that embodies that approach means that alternative approaches to designing an investment strategy, although consistent with the duties articulated in the *SIS Act*, create commercial risks for RSE licensees that they can only relieve by approaching the investment task using the SAA paradigm. This both creates systemic risk (because there is a lack of the diversity of perspective that promotes robustness in markets) and stifles innovation. I submit that neither are desirable but I note that they are both issues whose impact is not felt immediately.

3.	Does the calculation of actual RAFE and benchmark RAFE discourage non-performance related product features that members may value (such as customer service or platform products)? If so, can this be addressed without diminishing the test's focus on performance?

Clarity is one of the few virtues that the annual performance test possesses in its current form. Adapting the test to incorporate additional dimensions of utility will complicate reporting, calculation and interpretation. It ought to be resisted strongly. In addition to these pragmatic considerations, there is the methodological complication that the test currently purports to be objective but the utility of the additional features is inescapably a subjective matter (they will be valued differently by different people).

4.	What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes?

I have in the past documented my concern that the imposition of the annual performance test will be dysfunctional. [2] I continue to hold those concerns. I expect that the annual performance test will have an impact in both the short term and in the long term.

In the short term, the annual performance test will encourage the reduction in the number of MySuper products available to members. This will not occur by members leaving impugned funds but, as noted in my answer to question 6 below, by providing APRA with another lever to force RSE licensees to seek Successor Fund Transfers ('SFTs'). We have already seen this happen.

In the longer term, however, that effect will wane because in my experience RSE licensees have learned already how to avoid failing the test, so only those with pre-existing periods of underperformance risk getting caught. RSE licensees have already started to adapt their investment

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1 See for instance Gary P Brinson, L Randolph Hood, and Gilbert L Beebower 'Determinants of Portfolio Performance (1986) 42 *Financial Analysts Journal* 39; Chris R Hensel, D Don Ezra, and John H Ilkiw, 'The Importance of the Asset Allocation Decision' (1991) 47 *Financial Analysts Journal* 65.

2 For a summary see M. Scott Donald, 'Addressing chronic underperformance in the superannuation system' (2020) 32(4&5) *Australian Superannuation Law Bulletin* 74.

strategies to immunize their investment strategies against the risk of underperforming the test. They argue, correctly, that it is not in the best interests of members for the fund to fail a test and that that risk of failure outweighs the compromise to the investment strategy required in order to avoid failing the test. So it will be no more than a few years until the annual performance test no longer causes funds to leave the industry. However there will be a long term effect. Because in time all RSEs will adjust their investment strategies to immunize the risk from the annual performance test, the homogenization of the industry arising from the merger activity will be given further impetus. The propensity to take non-benchmark risks will be stifled by the fear of failing the annual performance test and any form of genuine product differentiation (other than branding) will evaporate. This is not without precedent. In Chile, an analogous test resulted in a peer-driven market dynamic that destroyed constructive competition and resulted in the collapse of an occupational pension system that had been rated as world-leading just a few years before.[3]

6.	Have the consequences been effective at encouraging trustees to improve their performance or merge with better performing funds? Are there ways this could be improved?

There is some evidence that RSE licensees have reduced fees in order to improve their prospects of passing future iterations of the annual performance test.

That said, there is a fundamental problem with the way in which this question has been framed. The notion of a 'better performing fund' is inherently an historical one. Both APRA and ASIC repeatedly cite the academically-supported conclusion that past performance is not a robust guide to future performance. It is true that RSE licensees can control the fees they charge but the idea that they can somehow ensure good performance into the future from other sources (such as their investment decision-making) is wishful thinking of a dangerous kind. Once the fees charged by RSE licensees are reduced to a sustainable minimum (ie enough to ensure that the RSE licensee can continue to provide the service in a prudent and skillful manner), apparent improvements over measured investment returns are just as likely to be the result of random chance as investment skill. As I noted in my submission on the annual performance test in March 2021, not only is the signal-to-noise ratio low (making inferences about skill very difficult to draw from performance histories), the investment processes being observed are themselves not stationary, so the statistical tests are invalid from the start. This is basic finance and econometric theory, and it is consistent with practical experience. So the idea that members are moving to 'better performing funds' is true only in the sense that they are moving to funds that have demonstrated better performance in the past, not that they are moving to funds that can be expected to have better performance in the future.

As noted above, one dynamic that is evident, however, is that APRA has used failure of the annual performance test as a lever to force RSE licensees with whom they have other misgivings to seek ways to leave the industry. The threat posed to future cashflows by the notification to members of the failed test, and then the threat of closure to new members if the failure is repeated, has to be reflected in the forward strategic planning required of all RSE licensees by SPS 515. This inevitably undermines the apparent commercial sustainability of the RSE licensee and justifies APRA's pressure on those RSE licensees to consider transferring their responsibilities to another via an SFT. This would be unexceptionable if the annual performance test were in fact a reliable indicator of skillful

[3] See for instance Claudio Raddatz and Sergio L Schmukler "Deconstructing Herding: Evidence from Pension Fund Investment Behavior" (2013) 43 *Journal of Financial Services Research* 99.

trust administration. For the reasons outlined above (amongst others), it is not. The result is that some capable RSE licensees are forced to leave the industry while others who fluked the annual performance test are able to continue.

9.	What would be the impact of extending the current performance test to other Choice products (such as single sector or retirement products)? How could any issues be addressed?

Notwithstanding the reservations I have about the annual performance test as whole, as I noted above one of its only virtues is its clarity of purpose. It is specifically designed to focus on the net return to members historically achieved by the superannuation products to which it applies, to the exclusion of all other factors. It does not purport to assess the desirability of the fund across other non-performance dimensions, nor does it purport to assess the suitability of any product that passes the test for any particular member. It is founded on a consumer protection objective that deems certain historical outcomes to be *ipso facto* harmful.

That consumer protection objective is only one objective at play in the superannuation system. Economic efficiency and accountability are also often expressed as objectives. Less frequently expressed, but equally important are the values of personal autonomy, inclusivity and equity. Each of these objectives and values finds expression in and is embedded to some extent in the regulatory scheme that shapes the superannuation system. However the balance between these objectives is not a technical issue; it is a policy decision.

That said, I submit that the choice architecture on which the superannuation system is founded provides a principled way of calibrating and arranging the annual performance test. Since 2012 the superannuation system has been structured to ensure that individual participants in the superannuation system can elect to exercise different levels of autonomy, from fully defaulting within a MySuper product to exercising full control in an SMSF. Choice is not imposed, but it is made available and supported.[4] Further, I submit that the bar for regulatory intervention for the purpose of consumer protection ought to be higher for MySuper products than for products where the individual has exercised an informed choice. Where an individual has chosen a superannuation fund or a product based on their fully-informed and independent assessment of their circumstances, needs, objectives and preferences, we ought to be hesitant to intervene in a paternalistic manner. We ought to ensure that the individual is in fact in a position to make a fully-informed and independent decision, for instance by requiring timely and comprehensible disclosure of the information that the individual might reasonably require to make such a decision. We ought also to ensure that the individual is aware that there are default arrangements in place and that therefore no decision is required of them. We ought also to ensure that the individual is aware of the potential consequences of whatever decisions they take. However, once those safeguards are in place I believe we ought to respect an individual's right to incorporate personal factors into their decision if they choose to do so.

[4] Jeremy Cooper, 'Super for Members: A New Paradigm for Australia's Retirement Income System' (2010) 3 *Rotman International Journal of Pension Management* 8, 11.

That suggests that the performance test ought to apply differently to MySuper and Choice products. The differentiation could apply at three different points: to the test applied, to the standard required and to the consequences of failure. More specifically:

i. The net performance of a Choice product ought to be measured against its publicly-disclosed benchmark, and not against the RAFE used in respect of MySuper products, because the investment strategy to which the benchmark responds is likely to be an important factor in the decision process of the members who chose the product;

ii. The performance shortfall before a Choice product has failed ought to be greater than is currently the case for MySuper products, in order that trustees of Choice products can take active investment decisions in pursuit of their bespoke objectives with less concern about falling foul of a bout of short-term underperformance ; and

iii. The more serious consequences applying to a second year of failure by a MySuper product ought not to apply to a Choice product, given failure in any year will require disclosure of that failure to all current and prospective members and those current and prospective members are, by definition, engaged and informed of both the failure and the reasons for that failure.

Arranging the annual performance test on this basis will also alleviate the need to create a faith-based supplement to the annual performance test, on which I made a submission to Treasury and a submission to the Economic Legislation Committee earlier this week. It will permit individuals to choose a superannuation product that embodies their religious beliefs. It will also permit individuals to express other personal preferences beyond those associated with religious faith, such as environmental or ethical concerns. It is my expectation that products that respond to such deeply-held preferences can operate very effectively in the Choice environment because those preferences are by definition sufficiently salient to motivate the individual to make an active choice. Moreover, this approach also does not absolutely preclude RSE licensees following faith-based approaches from offering MySuper products. It is thus less vulnerable to a charge that it impinges on the ability of individuals to ensure that their religious beliefs are not compromised by the way in which their superannuation arrangements are administered.

Finally, imposing the annual performance test on the basis of the system's choice architecture will also alleviate the emerging practical challenges in determining whether the annual performance test applies to a range of platform-based and other innovative fund structures that may or may not satisfy the legislative definition of a 'trustee-directed product'. This is of practical important because I expect that market forces will encourage regulatory arbitrage such that those challenges will multiply over coming years. Such structures inevitably exist in the Choice sector of the system and can be accommodated without difficulty by the adjusted regime described above.

17.	To what extent has the BFID required trustees to change their processes and procedures? Has this caused any unintended consequences or impacted member outcomes in any way?

Anecdotal evidence suggests that the guidance in the Explanatory Memorandum and from APRA in relation to what will now be required to satisfy the BFID has materially increased the amount of record keeping undertaken by RSE licensees. This is undoubtedly costly (although how costly is hard to gauge at this point given the lack of transparency in fund disclosures). It does however appear to have increased the attention paid by RSE licensees on the costs that they seek to have reimbursed from the fund.

One surprising impact that I have observed is that the heightened attention to expenditure appears to occur now even when the payments are being made out of the RSE licensees' own resources. This appears to occur because of the misconception that the BFID applies not just when the RSE licensee is exercising its powers and performing its duties qua trustee, but whenever the RSE licensee acts. This interpretation of the covenant in section 52(2)(c) is not consistent with the orthodox principles of statutory interpretation, nor with trusts and corporations law.

18.	Are there certain types of expenditure or activity that trustees are particularly concerned about being able to prove compliance with the BFID in respect of? Why is it difficult to demonstrate compliance? Should there be a materiality threshold?

I do not believe there should be a materiality threshold for the simple reason that the repetition of small amounts of aberrant expenditure can reflect a more serious, pervasive problem that would represent a breach of trust or the contravention of a statutory obligation. I do however note that this does not mean (as some in the industry have apparently tried to argue) that all items of expenditure have to be individually signed off by the trustee or its board. Corporate law has long recognised the lawfulness of systems of delegation that permit distributed decision-making to occur in a controlled manner across a diverse entity.[5] Policies and procedures can be put in place that permit smaller, repetitive expenditures (for instance) to be authorized outside the boardroom so long as appropriate monitoring regimes are in place to ensure that the delegations are implemented consistently.

19.	Is the reverse onus of proof the most appropriate way to achieve the objective of improving member outcomes?

I believe the 'reverse onus of proof' is inappropriate in the circumstances. Indeed there are grounds for suggesting, with respect, that even that description is inapt, as is the use in section 220A of the term 'evidential burden'. Unfortunately understanding why this is the case requires close attention to the detail of the mechanism and nuances in the law of evidence.

Section 220A introduces a presumption that an RSE licensee who is subject to regulatory proceedings in relation to a contravention of section 54B that relates to a breach of the covenant in section 52(2)(c) has breached the covenant. The RSE licensee can rebut the presumption by 'adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.' If the RSE can satisfy that requirement, the Regulator must then prove, on the

5 See M. Scott Donald, 'Delegation by Superannuation Fund Trustees' (2020) 37 *Company and Securities Law Journal* 319.

balance of probabilities, that the trustee did not breach the covenant. Presumably (although the statute does not make this clear) in this latter stage, the RSE can adduce further evidence in defence of the specifics of the Regulator's allegations.

That bespoke mechanism is not a simple reversal of the onus of proof. The RSE licensee is not in fact required to 'prove' that they have not breached the covenant. Strictly speaking, they also do not bear an 'evidential burden' (except perhaps in the final stage speculated upon in my description of the process) because the presumption goes to the heart of the alleged transgression – did the RSE licensee breach the covenant or not?[6] It is not a matter only of evidence but also of the attitude the court would take of the evidence once presented with it. That is to say, it is effectively a presumption of law.

One further complicating factor in assessing this mechanism is that although it is expressly limited to civil proceedings brought by the Regulator, the nature of those proceedings is inherently regulatory. As a number of commentators have identified over the past decade in relation to analogous *Corporations Act* matters, this gives such proceedings a peculiar hybrid nature.[7] Not only can one party (the Regulator) seek sanctions against the other (and not just remedies for harm caused) but that same party enjoys enhanced investigative and interrogative powers as a result of statute that the other party does not. Moreover, the standard of proof is a civil one (although perhaps the slightly more exacting *Briginshaw* standard).[8] So the Regulator enjoys the best of both worlds and the defendant is unusually vulnerable.

Bringing this back to the question posed, it is not clear to me why the presumption in section 220A is required in such a hybrid environment. Both APRA and ASIC have sufficient powers under relevant legislation to overcome any perceived asymmetry in information. Moreover, a presumption of contravention clearly weakens the position of the RSE licensee in any extra-curial negotiation designed to resolve matters without court involvement. Setting aside the quibbles raised above about the language describing the section 220A mechanism, there is no technical reason why Parliament cannot create a presumption in this form, but I submit that it creates an undesirable bias against RSE licensees. It is also likely to distort the regulators' enforcement priorities because prosecution related to the section 52(2)(c) will be preferred over possible causes of action where the presumption is not available.

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6 See J Dyson Heydon, *Cross on Evidence*, (9th Edn, 2013), [7015], citing Wigmore.

7 See for instance Vicky Comino, 'Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem' (2009) 33 *Melbourne University Law Review* 802; Tom Middleton, 'The Difficulties of Applying Civil Evidence and Procedure Rules in ASIC's Civil Penalty Proceedings under the Corporations Act' (2003) 21 *Company and Securities Law Journal* 507. Also Australian Law Reform Commission, *Principled Regulation Report – Federal Civil and Administrative Penalties in Australia* (Report No 95, 2002), [2.47].

8 From *Briginshaw v Briginshaw* [1938] HCA 34.

Concluding comments

My criticisms of the annual performance test and section 220A ought not to be taken as suggesting that I doubt the importance of focusing on member outcomes. But how we go about promoting that focus matters. Ill-designed tests and legal provisions distort the regulatory scheme and risk causing dysfunction in the system. I encourage Treasury to consider the observations and recommendations in this letter, and in the other feedback provided by the industry, in that light.

Please do not hesitate to contact me if you have any questions or require any further information or elaboration.

Yours sincerely

M Scott Donald PhD CFA
Associate Professor
UNSW Sydney