Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012

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Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012

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House: House of Representatives

Portfolio: Treasury

Commencement: Schedule 1 commences on 1 July 2013, with other provisions commencing at various times including on Royal Assent or the day after Royal Assent or in conjunction with related provisions in the Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012 (once enacted).

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bill’s home page, or through http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation. When Bills have been passed and have received Royal Assent, they become Acts, which can be found at the ComLaw website at http://www.comlaw.gov.au/.

Purpose

The Bill proposes three major changes to the Superannuation Industry (Supervision) Act 1993 (SIS Act), to:

• apply new trustee duties to registrable superannuation entity (RSE) licensees of an RSE that offers a MySuper product
• expand the general duties of RSE licensees and
• introduce a power for the Australian Prudential Regulation Authority (APRA) to make prudential standards.

Context of this Bill in relation to other proposed changes

This Bill is the second part of the ‘Stronger Super’ package and is one of several superannuation-related changes either being implemented or proposed by the Government. Other significant changes include:

• progressively lifting the superannuation guarantee rate from 9 per cent to 12 per cent by 2019–20 — this measure is likely to significantly increase the flow of funds into superannuation over the next decade
• future of financial advice (FOFA) measures — a package of measures to change the obligations and remuneration structure of financial advisers. These changes intersect with the superannuation industry to the extent that many, if not most, superannuation funds provide financial advice and members can be paying for this advice in a number of different ways
• the ‘Superstream’ package of measures — aimed at improving the efficiency of backoffice administration of superannuation funds through the use of data and payments standards,

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automatic consolidation of low-value inactive accounts and regular information to employees on employer contributions and
• the introduction of ‘MySuper’ — a simplified default superannuation product with additional licensing requirements, prescribed rules for fees and specific duties on the trustees of superannuation funds in relation to a MySuper product offered by the fund.

Most of the measures listed above require some legislative change to implement. Some have already progressed into the House of Representatives and have been referred to various committees¹ or have been passed by the House of Representatives or the Senate.² Draft Bills for elements of the Superstream package relating to data and payment standards were released on 9 February 2012.³ Consultation by the APRA on some of the detailed arrangements relating to prudential standards (including governance standards⁴) is already underway, as is consultation by the Australian Taxation Office (ATO) on data payment standards.⁵

Since the Bill was introduced in the House of Representatives, the parts of the superannuation industry announced voluntary governance-related codes and guidelines in March 2012:

• for profit superannuation funds — the Financial Services Council announced that a standard on superannuation fund governance would apply to its members, which would include requirements that superannuation funds must have an independent chair, the majority of directors must be independent, remuneration of directors and senior management must be disclosed where paid

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from the trust and directors must not hold multiple and competing superannuation fund board positions and

- not for profit superannuation funds — the Australian Institute of Superannuation Trustees (AIST) in conjunction with the Industry Funds Forum released a governance framework for not for profit superannuation funds, which covered a range of matters including board structure, managing conflicts of interest, and remuneration and disclosure arrangements.

The Government has also recently announced proposals for greater disclosure of superannuation fund executives’ earnings and investments. This would require superannuation funds to publish on their websites details of director and executive pay, details of what assets the fund has invested in and an up-to-date ‘product dashboard’, setting out information on target investment returns, past performance against targets, investment risk, liquidity and fees in relation to each product offered by the fund.

The Explanatory Memorandum notes that further changes will be introduced in several future tranches of legislation including:

- rules of the charging of financial advice deducted from member accounts and charging for intra-fund advice
- arrangements for the transition of member accounts from existing default superannuation products to MySuper products and
- further requirements in relation to insurance.

**Background**

The Government first announced that the Australian superannuation system would be subject to a comprehensive review on 28 April 2009. This announcement included reference to a ‘Communiqué

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of principles for superannuation’, which was to guide the Review.\footnote{11} This Review’s terms of reference and other details were announced on 29 May 2009.\footnote{12}

This Bill, and the others that comprise the Stronger Super package, are largely the outcome of the Cooper Review.

An overview of the Cooper Review, the Government’s response to the review, policy development and general views of the Coalition in relation to the Review and MySuper are summarised in the Bills Digest for the Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2011.\footnote{13}

**Cooper Review governance-related recommendations and government response**

The Cooper Review considered that a higher level of governance was generally required for superannuation funds, partly due to the mandatory nature of the superannuation system.\footnote{14} Some of the general governance-related recommendations included:

- the creation of a distinct new office under statute, that of ‘trustee-director’, whose duties, powers and standards required of this office would be recorded clearly in the SIS Act. These statutory duties would enhance, expand and clarify the duties set out in section 52(2) of the SIS Act as well as appropriately adapt the chapter 2D directors’ duties from the Corporations Act
- changing the structure of trustee boards, including their size and the tenure of trustee-directors to include a minimum number of ‘non-associated’ trustee-directors on all superannuation trustee boards and
- the establishment of a ‘Code of Trustee Governance’ to reflect the unique context of a superannuation fund.\footnote{15}

In addition to these general governance-related recommendations, the Review also made specific recommendations on the creation of specific trustee obligations (including a test to require trustees

\footnote{11} Ibid.
\footnote{15} Ibid.

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to examine scale on an annual basis) in relation to MySuper and giving APRA a general standards making power.\(^{16}\)

**Initial Government response**

The Government response to the Cooper Review, issued on 16 December 2010, supported a number of governance-related recommendations, including giving APRA a general standards making power in relation to superannuation and enhanced trustee obligations to give effect to a single diversified investment strategy and to conclude on an annual basis, whether its MySuper product had sufficient scale to continue providing optimal benefits to members.\(^{17}\)

Some of the governance-related recommendations **not** supported by the Government, and the reasons why these were not supported included:

- that it no longer be a mandatory requirement for trustee boards to maintain equal representation in selecting its trustee directors — The Government considered that the current arrangements requiring equal representation remain appropriate in ensuring members are able to participate in the management and protection of their retirement savings (Recommendation 2.4) and

- for those boards that have equal representation because their company constitutions or other binding arrangements so require, the SIS Act be amended so that no less than one-third of the total number of member representative trustee-directors must be non-associated and no less than one-third of employer representative trustee-directors must be non-associated — The Government considered that beyond the existing regulatory framework, the composition of a trustee board was a matter for the board to determine, but will refer to APRA the need for guidance on managing conflicts of interest (Recommendation 2.7).\(^{18}\)

The Government indicated that while it supported in principle the creation of an office of ‘trustee director’, it would ‘consider whether the proposed arrangements achieve a more accountable and efficient trustee governance regime’.\(^{19}\)

**Consultation panel**

The Government indicated that further consultation would be undertaken with stakeholders on the implementation of the reforms, commencing in early 2011.\(^{20}\) The Minister for Financial Services and Superannuation announced the membership of the consultation panel on 1 February 2011, with the

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16. Ibid., pp. 25 and 57.
18. Ibid., p. 27.
19. Ibid., p. 23.
20. Ibid., p. 4.

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panel to be supported by several working groups (covering MySuper, governance, self-managed superannuation funds, and SuperStream).21

The Consultation Panel process was completed at the end of June 2011 and the Panel’s report was released by the Government on 21 September 2011.22 Key aspects of the report relating to governance were:

- **office of trustee director**

  Whilst supporting the broad initiative to more clearly articulate the obligations of a director of a trustee company, the consensus is that the creation of a new office of trustee-director is not required. It is suggested that, rather than creating a new office of trustee-director, reforms could focus on clarifying in the SIS Act those duties that appropriately apply to individual directors rather than to the corporate trustee (for example, to act honestly and to exercise independent judgement).23

- **scale test for MySuper**

  There is support for the requirement that the trustee of each MySuper product must be required to examine and conclude annually whether the MySuper product has sufficient scale to continue providing optimal benefits to members. It was noted that the scale of the whole fund (assets and members), as well as the MySuper product within the fund, may be relevant in making this judgement however it was concluded that while size was relevant it was not the only indicator of likely success. It was recognised that there would be cases where smaller, appropriately resourced and skilled funds would be able to demonstrate that they could meet the requirement to provide optimal benefits to members.24

**Final Government response**

The final Government response, released on 21 September 2011, endorsed many of the consultation panel’s recommendations, opposing the establishment of an ‘office of trustee director’. The Government noted that:

> During consultation, a number of practical difficulties were identified with this recommendation. As a result, the Government will instead focus on addressing the particular issues identified by the Super System Review. These changes will include:

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23. Ibid., p. 21.

24. Ibid., p. 2.

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- introducing a duty for trustees and directors to give priority to the interests of fund members when that duty conflicts with other duties;
- strengthening the requirements for individual directors in relation to managing conflicts of interest;
- increasing the standard of care, skill and diligence required of trustees and directors of corporate trustees to that of a prudent person of business;
- clarifying the duties applying to individual directors of corporate trustees to act honestly and to exercise independent judgment; and
- introducing a requirement for trustees to devise and implement an insurance strategy and impose a statutory duty on trustees to manage insurance with the sole aim of benefiting members.25

**Committee consideration**

The Bill was referred to the Joint Committee on Corporations and Financial Services (PJC) for inquiry and report.26

In its report, tabled on 19 March 2012, the Committee recommended that the Bill be passed.27 However, the Minority report by the Coalition members of the Committee recommended that the ‘scale test’ be removed from the Bill.28

While specific criticisms of the Bill by submitters to the inquiry are included in the ‘Main Provisions’ section of this Bills Digest, the following are some of the more general comments made:


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• AMP Finance (AMP) considers that the Bill ‘in its current form, is overly complex, unclear and imposes unduly onerous obligations on trustees and their directors’.

• the Law Council of Australia (LCA) is critical of the Bill’s ‘tendency to use the explanatory memorandum to ‘fill in the gaps’ left by the legislative provisions themselves’. It suggests that ‘[i]t is dangerous ... if the actual words are clear on their face, since generally speaking recourse to extraneous material is only permitted to clarify ambiguity or obscurity’. The LCA also notes that ‘APRA is ... given the task of providing much of the detail, which may not always be an appropriate delegation of the legislative function’, and

• Australian Super submits that:

  Under the current legislative proposals, a superannuation fund offering MySuper must offer a product with a standard set of fees to all prospective members, but the product actually received by members may vary according to arrangements between their employer and the fund. This matter requires further consideration, because of its potential to undermine the operation and intent of MySuper and compromise retirement outcomes.

  The practical impact of permitting variation in fees for different employer arrangements is that superannuation funds will be able to transfer - “flip” – members from an artificially low-priced MySuper product, offered to all employees of that employer, to a much higher-priced MySuper product in the same fund when they leave that employer.

Financial implications

The Explanatory Memorandum notes that the Bill has no significant financial impact on Commonwealth expenditure or revenue.

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31. The Law Council points in this regard to paragraph 15AB(1)(b) of the Acts Interpretation Act 1901.

32. Law Council of Australia submission, op. cit.


34. Explanatory Memorandum, p. 3.

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Schedule 1—Trustee obligations

Key provisions

Enhanced obligations for trustees that offer a MySuper product

Financial interests

Item 9 inserts proposed paragraph 29VN(a) into the SIS Act which requires trustees to promote the financial interests of members of a MySuper product, particularly returns to MySuper product beneficiaries (after the deduction of fees, costs and taxes).

The Explanatory Memorandum suggests that this would require a trustee to make informed judgments about the MySuper product, so as to secure the best financial outcome for beneficiaries. However, sustained low returns would not necessarily indicate a breach of the obligation, and a MySuper product would not be required to be given preference over other members of the fund.35

Stakeholder comment

The Australian Institute of Superannuation Trustees (AIST) submits that ‘the additional “financial interests” obligation on trustees in section 29VN [should] not be clouded, diminished or distorted by considerations other than the pursuit of optimal net returns to members (having regard to risk considerations)’.36

AIST also considers that:

...the pursuit of optimal net returns to members having regard to risk considerations and the safe stewardship of members’ benefits should be the overwhelming obligation upon trustees of MySuper products, and this obligation should not be clouded, diminished or distracted by other considerations including scale.37

AMP has similar views, and suggests the redrafting of proposed section 29VN ‘so that it is clear that the long established principle that trustee duties are based on decision making processes is not overturned and replaced with an outcomes based test’. AMP also suggests amendment reference in


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the proposed provision to ‘the concept of risk as it applies to ‘returns’ or by specifically referring to ‘risk-adjusted returns’.  

With respect to proposed paragraph 29VN(a), the Law Council of Australia (LCA) proposes that:

...rather than requiring trustees to “promote returns” ... it would be preferable to delete section 29VN(a) altogether and to rely instead on section 52 in relation to the proper formulation of investment strategies and on the proposed MySuper fees and charges provisions in relation to the level of costs being borne by MySuper members. Alternatively, some reference to “10 year risk-adjusted returns” should be included for consistency with other proposed provisions.  

Annual determination of scale

Proposed paragraph 29VN(b) requires trustees to make a single, annual determination whether the financial interests of beneficiaries that hold the MySuper product are disadvantaged compared to beneficiaries that hold a MySuper product in other funds due to insufficient scale in terms of members or assets.

Stakeholder comment

In relation to proposed paragraph 29VN(b), the Association of Superannuation Funds Australia Limited (ASFA) submits that:

... the current wording of the scale test is problematic. On speaking to Treasury, we believe that guidance will be provided by APRA. In terms of being able to provide for fund members, size of portfolio and number of members are certainly two factors, but there are other factors as well. In our view, fund trustees, as part of their best interest duties, have to look each year at whether or not they are able to provide services in the best interests of their members. So our initial view is very much that the—and certainly part of the consultation process—whole scale test may produce the wrong results.

ASFA also submits that ‘given that trustees are under a duty to act in the best interest of members - the test in proposed paragraph 29VN(b) is unnecessary, and may drive trustees to make short-term decisions on how they operate and how they invest the fund which may not be in the best long-term interest of members’. 

38. AMP Finance, submission, op. cit., p. 5.
39. Law Council of Australia, submission, op. cit., p. 4.
41. Association of Superannuation Funds of Australia Limited, Submission to the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Superannuation Legislation Amendment (MySuper Core
Corporate Super Association (CSA) also considers the scale test unnecessary, taking the view that ‘the investment and risk covenants for all RSE trustees are sufficient requirements that trustees should not be operating a fund or MySuper product when assets and members numbers do not lend sufficient economies of scale to support a viable product’.42

Mercer (Australia) Pty Ltd (Mercer) submits that:

The proposed test concentrates on comparisons with other funds and has an undue emphasis on financial interests, ignoring other significant features of the fund such as service levels, insurance benefits and risk.43

AMP submits that:

The requirement to measure “disadvantage” ... by comparing the MySuper beneficiaries in other funds would be almost impossible to comply with in practice given the number and size of funds in the marketplace and the number of MySuper beneficiaries there are likely to be in those funds. It seems to require an assessment to be made against all other funds with MySuper products as the way section 29VN(b) is drafted does not appear to allow the trustee to select only some funds against which to conduct the comparison.44

PJC report

In its minority PJC report, Coalition members note the criticisms of the scale test and call for its removal from the Bill. Coalition members submit that ‘[a]lthough there can be benefits that accrue to consumers from investing in large pooled investments, a scale test for super funds would have a number of negative consequences’, including the introduction of a barrier to market entry, and the wide and subjective nature of the test.45


44. AMP Finance, submission, op. cit., p. 5.

45. Coalition Members and Senators, Dissenting report, Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2011 and
However, the PJC majority report disagrees with this view, concluding that:

... witnesses’ concern with the scale test in proposed paragraph 29VN(b) of the Trustee Obligations Bill is misplaced. The test is not intended to be absolute: importantly, paragraph 29VN(a) provides trustees with an obligation to promote the financial interests of beneficiaries of the fund. As Treasury has explained, the reference in proposed paragraph 29VN(b) to the number of members and size of assets of the fund is simply to indicate that one of the reasons that a small fund may not be performing is that it may not have sufficient scale. It is not, as some have argued, to claim that all small funds underperform because of their size or even to suggest there is strong correlation between these factors.46

Coalition amendment

In the House of Representatives, the Coalition moved an amendment to omit the scale test from the Bill47, which was defeated.48

Additional obligations for directors of corporate trustees of funds that offer a MySuper product

Proposed section 29VO sets out additional obligations for a director of a corporate trustee of a regulated superannuation fund that includes a MySuper product. Each director is required to exercise a reasonable degree of care and diligence, equivalent to that which would be exercised by the director of a ‘superannuation entity director’ (defined in subsection 29VO(3)) in the corporate trustee’s circumstances, to ensure that the corporate trustees carry out their obligations under proposed section 29V (subsections 29VO(1) and (2)).

Contravention of trustee or director obligations in relation to MySuper products

Proposed section 29VP proscribes the contravention of proposed sections 29VN and 29VO (subsection 29VP(1)). Although a contravention of these provisions is not an offence and does not

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make a transaction invalid (subsection 29VP(2)), action may be taken to recover any loss or damage (subsection 29VP(3)).

**Defence to an action for loss and damage**

Item 14 replaces existing subsections 55(5) and (6) with proposed subsections 55(5) and (6). Proposed subsection (5) provides that it is a defence to an action for loss or damage as a result of the making of an investment by or on behalf of a trustee of a superannuation entity if the defendant establishes that they have complied with all the covenants in proposed sections 52 and 54A and existing section 53 (see below), and all the obligations in proposed sections 29VN and 29VO.

Proposed subsection (6) provides that it is a defence to an action for loss or damage suffered by a person as a result of the managements by the trustee of a superannuation entity if the defendant establishes that they have complied with all the covenants and obligations in these provisions.49

**Stakeholder comments**

Mercer and AIST submit that the proposed action for damages for breach of proposed sections 29VN or 29VO should be replaced with a regulator initiated action (such as a fine).50

A similar point is made by the LCA:

...the new enhanced trustee obligations duties bear no resemblance to trust law duties. As such, the penalty for their noncompliance should be purely statutory, such as withdrawal of the trustee’s RSE authorization or the imposition of penalties and fines. 51

AMP also adopts a similar position, suggesting that ‘it is inappropriate to impose civil liability for breach of these new enhanced trustee duties’. AMP considers that because ‘they do not embody trust law duties and are uncertain in their application, the penalty for breach of these duties should be statutory based such as cancellation of the trustee’s RSE licence authorisation or the imposition of fines’. 52

In response to such views, the PJC majority report draws attention to ‘the defences in proposed subsections 55(5) and 55(6) of the Bill’ which ‘state that it is a defence if the defendant establishes that they have complied with the covenants in sections 52 to 53 and prescribed under section 54A, and the obligations referred to in section 29VN and 29VO that are relevant to the circumstances’.53

The LCA considers that[a]s a practical matter, it may be difficult, if not impossible, for a person new to directorships and/or to superannuation to meet the required standard’ and that this also ‘throws

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49. Presently, under these subsections, compliance is only required with paragraphs 52(2)(f) and (g) respectively.
50. Mercer, submission, op. cit., and AIST, submission, op. cit.
51. Law Council of Australia, submission, op. cit., p. 6.
52. AMP Finance, submission, op. cit., p. 6.

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doubt on the on-going viability of equal representation, in particular board structures that provide for member-elected directors’. 54 The LCA recommended that ‘the director standard should reflect the prudent person of business standard’. 55

Corporate Super Association (CSA) considers that the proposed amendments to subsection 55(5):

... would provide a defence to an action for investment loss or damage for trustees and trustee directors only if they have adhered to all covenants under sections 52 and 54A as well as applicable obligations under sections 29VN and 29VO. 56

CSA considers this ‘a significant increase in requirements for a successful defence which previously only included compliance with investment covenants’, favouring maintenance of the status quo. It also considers that the proposed covenants for individual directors should be abandoned as the same objective is attainable ‘by training and other requirements’. It submits that those suffering loss ‘have sufficient recourse against the trustee as a whole’. 57

Covenants for registrable superannuation entities (RSEs)

General covenants

Existing subsection 52(2) of the SIS Act sets out covenants to be included automatically in governing rules of superannuation entities. 58 Item 12 replaces this provision with proposed subsection 52(2) which, while retaining some of the existing duties for trustees59, also creates the following new duties.

Standard of care, skill and diligence

The existing law requires trustees to exercise the same degree of care, skill and diligence, in managing the fund as an ordinary prudent person would exercise. However, proposed paragraph 52(2)(b) requires the trustee to exercise the same degree of care, skill and diligence in relation to all matters affecting a registrable superannuation entity as a prudent superannuation trustee would

54. Law Council of Australia, submission, op. cit., p. 6.
55. Ibid.
56. Corporate Super Association, submission, op. cit., p. 5.
57. Ibid.
58. Section 52 of the SIS Act may be accessed through the following link: http://www.comlaw.gov.au/Details/C2012C00384
59. To act honestly in all matters affecting the entity (proposed paragraph 52(2)(a)); to perform the trustee’s duties and exercise the trustee’s powers in the best interests of beneficiaries (proposed paragraph 52(2)(c)); to keep the money and other assets of the entity separate (proposed paragraph 52(2)(g)); not to enter into any contract (or do anything else) that would prevent the trustee from (or hinder the trustee in) properly performing or exercising its functions and powers (proposed paragraph 52(2)(h)). As presently, this latter does not prevent the trustee from engaging or authorising persons to do acts or things on behalf of the trustee (proposed subsection 52(5)); if there are any reserves of the entity, to formulate, review regularly and give effect to a strategy for their prudential management (proposed paragraph 52(2)(i)); to allow a beneficiary access to any prescribed information or any prescribed documents (proposed paragraph 52(2)(j)).
exercise in relation to an entity of which it is trustee, and on behalf of the beneficiaries for which it makes investments.

The Explanatory Memorandum states that the changes would bring the Commonwealth legislation into line with existing state and territory legislation relating to professional trustees.60

Stakeholder comment

CSA does not accept that the proposed amendment would bring the Commonwealth legislation into line with that of the states and territories:

...State and Territory legislation (for example, section 6 of the Victorian Trustee Act 1958) does not contain a universal requirement for all trustees to be professional trustees, nor to exercise the skills of professional trustees, nor does it contain a reference to the model for care, skill and diligence being a professional director ‘investing money on behalf of beneficiaries’, an addition which seems to import an implication that the level of skill required is not just that of a professional trustee director but one who has specific investment management expertise. We believe that this raising of the bar is not just a step but several significant steps, and well beyond the requirements under the Trustee Acts.61

ASFA submits that:

There is little to be gained by stating that the standard of care, skill and diligence expected of a (superannuation) trustee is that which a prudent (superannuation) trustee would exercise. If the policy intent were to raise the standard then we submit that it would be preferable to refer to a “prudent person of business”. This was the recommendation of the Cooper Review and was supported by the Peak Consultative Group in its report to Government.62

Conflicts of interests and duties of trustees

Where a conflict exists and general law allows a trustee to proceed despite the conflict, proposed subparagraphs 52(2)(d)(i)-(iv) require trustees to: give priority to the duties to and interests of beneficiaries over the duties to and interests of other persons63; to ensure that their duties to beneficiaries are met despite the conflict; to ensure that the interests of beneficiaries are not adversely affected by the conflict; and to comply with any prudential standards for conflicts developed by APRA.

AMP submits that ‘the new duty of priority will not align with the trustee’s equitable duties, it is unclear as to its operation and, in certain circumstances, it will be impossible for a trustee to comply

60. Explanatory Memorandum, p. 20.
61. Corporate Super Association, submission, op. cit., p. 4.
62. Association of Superannuation Funds of Australia Limited, submission, op. cit., p. 5.
63. This duty would override any conflicting duty that an executive officer or an employee of the trustee has under Part 2D.1 of the Corporations Act 2001 or Division 4 of Part 3 of the Commonwealth Authorities and Companies Act 1997: proposed subsection 52(4).
with’. AMP suggests replacement of the requirement to achieve certain outcomes with one requiring the trustee to ‘have processes in place that are designed to achieve those outcomes’. It also recommends regulations prescribing the specific areas that APRA must have regard to with respect to conflict under proposed subparagraph 52(2)(d).

Duty to act fairly

Proposed paragraphs 52(2)(e) and (f) require trustees to act fairly in dealing with classes of beneficiaries within the entity and with beneficiaries within a class.

The new provisions do not limit transactions with related parties where the transactions are in the best interests of beneficiaries and permitted under the general law (proposed paragraph 52(2)(d)). Specific requirements that must be met are:

- for trustees to give priority to the duties to and interests of beneficiaries over the duties to and interests of the trustee to other persons
- that the trustee must ensure their duties to beneficiaries are met despite the conflict. The duty to beneficiaries includes, but should not be limited to, the duties to act in the best interests of beneficiaries and to exercise the relevant degree of care and diligence
- that the interests of beneficiaries must not be adversely affected by the conflict
- the trustee must comply with any prudential standards in relation to conflicts that are developed by APRA.

Investment covenants

Proposed paragraph 52(6)(a) requires trustees to take account not only the whole of the fund, as presently, when considering investment options, but also for each investment option. Additional investment covenants for trustees to comply with are the availability of valuation information, expected taxation consequences and expected costs (proposed subparagraphs 52(6)(a)(iv), (vi) and (vii)).

Stakeholder comment

FSC considers that the effect of proposed paragraph 52(6)(a) would be to require trustees to investigate each listed equity. It considers that this would be impractical for certain choice product investment options, such as listed equities and term deposits, to which ‘concepts such as liquidity and diversification are not applicable’. FSC considers the existing ASX investment governance framework that applies to listed corporations ‘is already of a very high standard’ and that ‘trustees should be able to rely on this without a separate governance framework.’

64. AMP, op. cit., pp. 6 and 7.
65. Ibid., p. 6.
66. Ibid.
67. Financial Services Corporation, submission, op. cit., p. 10.

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ASFA submits that:

If a fund offers a member investment choice, then the concept of an investment strategy for the whole of the entity does not make sense – the trustee formulates a strategy for each of the options offered but the composition of the entity’s investments ultimately is determined by the relative amounts invested in each option by the members.

... while the Explanatory Memorandum (“EM”) states that this is intended to include individual investments, it is not readily apparent how the concept of an investment strategy can have application to a single asset investment, such as where the member is able to invest in a specific share or a specific term deposit. It is unclear as to how the requirement to formulate an investment strategy would apply to such an option. 68

Insurance covenants

Proposed paragraph 52(7)(a) requires each trustee of an RSE to formulate, review regularly and implement an insurance strategy for beneficiaries of the RSE. The elements that must be addressed in the insurance strategy are set out in proposed subparagraphs 52(7)(a)(i)-(iv).

Each trustee of an RSE is required to consider the cost to all members when offering insurance of a particular kind or level (proposed paragraph 52(7)(b)), and should only offer insurance of a particular kind, or at a particular level, if it does not inappropriately erode the retirement income of beneficiaries (proposed paragraph 52(7)(c)).

This is said by the Explanatory Memorandum to mean that the obligation applies at the level of the entire membership of the RSE and is not tied to the circumstances of individual members. 69

Each trustee of an RSE will be required to do everything that is reasonable to pursue an insurance claim on behalf of one or more of its beneficiaries, if the claim has a reasonable prospect of success (proposed paragraph 52(7)(d)). Trustees should consider the likely costs and benefits (with respect to all affected members of the RSE) of pursuing an insurance claim in determining whether it is reasonable to pursue a potentially successful claim.

Stakeholder comment

In view of the operational risks relating to insurance administration, Professional Financial Solutions (PFS) recommends expansion of the proposed insurance strategy requirements to include requirements that ‘the terms and conditions of the superannuation fund’s insurance policy/ies are accurately reflected in administration systems’ and that they are ‘correctly communicated to its members’. 70

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68. Association of Superannuation Funds Australia Limited, op. cit., p. 6.
69. See Explanatory Memorandum, p. 25.
70. Professional Financial Solutions, Submission to the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2011 and

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PFS considers that proposed paragraph 52(7)(c) places trustees ‘in a virtually impossible position’ because:

Trustees generally devote a considerable amount of time, cost and energy to understanding the membership profile of their fund. They generally have a good understanding of their members’ age and gender and often a broad idea of the industries in which they work. They also have some sense of members’ salaries, based on employer contributions, and know their members’ account balances within their particular fund. However, trustees only have a superficial knowledge of the financial situation of any of their funds’ members. Regardless of any common demographics, trustees can have no certainty of financial commonality of their fund’s beneficiaries.

For some members, insurance cover will be their priority, for others it will not. Trustees can only do their best in formulating default insurance options, based on a broad understanding of their memberships. Ultimately, the value of cover available has to be for each individual to decide.71

PFS also considers that:

There needs to be a requirement for reinstatement of cover terms to be considered in respect of the financial interest of members. It could well not be in the financial interest of a member receiving spasmodic employer contributions to continually have their replenished account balance completely eroded by the reintroduction of insurance and the respective premiums.72

Covenants relating to risk

Proposed paragraph 52(8)(b) requires RSE licensees to maintain and manage financial resources for each RSE under their trusteeship, covering the operational risk of the RSE in accordance with prudential standards.73

The Explanatory Memorandum explains that ‘the risk’ being addressed in this proposed provision is the risk that a superannuation fund may suffer due to inadequate or failed internal processes, people and systems or from external events: it is distinct from investment or market risk.74 The Explanatory Memorandum also advises that details of the requirements for financial resources to cover operational risk are to be set out in a prudential standard determined by APRA.75

Restrictions are imposed by the Bill on recouping operational risk losses from RSE assets, as this would ‘defeat the purpose of maintaining financial resources to cover operational risk, which is

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71. Professional Financial Solutions, submission, op. cit., p. 3.
72. Ibid.
73. The requirement will not apply to self managed superannuation funds (SMSFs).
74. The current requirements are outlined in the Explanatory Memorandum at p. 26.
75. Explanatory Memorandum, p. 27.

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designed to protect current RSE members from bearing the full cost of an operation risk loss’ (item 18, proposed paragraph 56(2A)(a); item 16, proposed subsection 56(1); and item 17, proposed paragraph 56(1)(b)).

Additionally, an RSE licensee must exhaust all the financial resources maintained to cover an RSE’s operational risk before being indemnified for the cost of operational risk from the RSE’s other assets (item 18, proposed paragraph 56(2A)(b)).

Proposed paragraph 52(8)(a) introduces a new duty requiring each RSE trustee to develop, implement and regularly review a risk management strategy. A number of existing provisions imposing conditions on RSE licences requiring licensees to have a compliant risk management strategy, and detailed requirements relating to the existing risk management strategy licence condition are repealed.

Covenants for directors of corporate trustees of RSEs

Proposed subsection 52A(1) provides that where the governing rules of an RSE do not contain covenants to the effect of those in proposed subsection 52A(2), the rules are taken to contain covenants to that effect. The covenants in subsection 52A(2) reflect many of the covenants in subsection 52(2). However, the focus is on the individuals who are directors of corporate trustees of RSEs. Paragraph 52A(2)(b) and (f) require each director of a corporate trustee to exercise the same degree of care, skill and diligence that a prudent superannuation entity director would exercise in relation to the entity where he or she is a director of the trustee and that trustee makes investments on behalf of the beneficiaries of the entity.

The Explanatory Memorandum explains that:

> The required standard of care, skill and diligence is an objective standard. Care and diligence go to the way in which the director applies himself or herself to their functions. The level of skill required does not necessarily require particular qualifications, and new directors will not be expected to have the level of skill and knowledge of an experienced director immediately. It is not intended that each director will have the same skills but rather that each understand the business of the trustee and its regulatory framework and be in a position to contribute to meetings of the trustee. APRA will provide further guidance on these matters.

Stakeholder comment

CSA expresses concern that ‘this position is left for explanation in the EM and by APRA pronouncement and that the EM indicates an approach that may be more lenient than the

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76. Ibid., p. 28.
77. Details of the proposed repeals are set out more fully in the Explanatory Memorandum, p. 29.
78. Ibid., p. 31.

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legislation specifies’. It considers that, in the interests of certainty, the legislation should be amended to reflect this position.\(^79\)

The LCA is also critical of this provision, submitting, amongst other things, that:

...directors of a superannuation fund would be placed in an adverse position as regards liability when compared against, for example, directors of banks. As a parallel, under Chapter 5C of the Corporations Act, officers of a responsible entity have direct duties by virtue of section 601FD, but civil liability does not attach to these duties. Civil liability only attaches to a breach of duty by the responsible entity itself (Corporations Act, s. 601MA). \(^80\)

FSC has similar concerns about what it regards as a ‘significant departure’ from the current corporations regime:

...general law operates so that the rights, privileges, duties and liabilities ascribed by law to the company are not ordinarily ascribed to its directors. The Director Covenants circumvent general law by ascribing the corporate trustee covenants to the directors of the trustee company. While the FSC does not dispute the ability of statute to depart from this doctrine, to date statute only departs in the most serious of circumstances (eg trading during insolvency (section 588G of the Corporations Act), share capital transactions causing insolvency (section 588G), payment of improper dividends (section 254T of the Corporations Act) and company debts where the company has no indemnity from trust assets (section 197 of the Corporations Act). Section 52A departs from this regime by exposing directors even in the ordinary operation of the corporate trustee.\(^81\)

Covenants for self managed superannuation funds (SMSFs)

**Proposed section 52B** maintains the existing covenants to be included in the governing rules of SMSFs, with some small changes to the wording to reflect equivalent improvements made to the interpretation of the general covenants.

**Proposed section 52C** maintains, without change, the existing covenants to be included in the governing rules of SMSFs relating to directors.

**Other**

**Item 13** inserts **proposed section 54A** (reflecting existing subsections 52(5) to (7)), to enable the making of regulations prescribing a covenant to be included in the governing rules of a superannuation entity. Covenants may elaborate, supplement or otherwise deal with any aspect of a matter in a covenant or other provision in the Act, but must be capable of operating concurrently with the covenants and the Act.

79. Corporate Super Association, submission, op. cit., p. 3.

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Item 19 inserts proposed paragraph 58(2)(d) which provides that it is permissible for a beneficiary to give a trustee directions to take up, dispose of, or alter the amount invested in an investment option.

Item 20 replaces existing section 115 with proposed section 115 which seeks to ensure that RSE licensees are able to maintain operational risk reserves by requiring governing rules not to prohibit such reserves, and providing that rules inconsistent with this will be invalid to the extent of the inconsistency.

Schedule 2—Prudential standards

Background

Schedule 2 of the Bill proposes to establish a power for APRA to set ‘prudential standards’ for those parts of the superannuation industry that it regulates.

The term ‘prudential standards’ generally refers to regulatory controls imposed on a financial institution to protect the interests of depositors or other creditors. In regulating the banking and insurance industries, where APRA has formal standards-making powers, areas covered by prudential standards include:

- capital adequacy
- risk management
- outsourcing arrangements
- audit and related matters and
- governance including the roles and responsibilities of the board and senior management and board composition.\(^82\)

Under current arrangements, APRA regulates the superannuation industry (with the exception of Self Managed Superannuation Funds (SMSFs) which are primarily regulated by the ATO) through licence conditions and other specific obligation established in the Superannuation Industry (Supervision) Act 1993.

To assist in regulating the industry, APRA has published a range of material to guide superannuation trustees and participants. This material is published in the form of ‘circulars’, best practice guides’, ‘superannuation guidance notes’ and ‘prudential practice guides’.\(^83\)

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As noted above, the Cooper Review recommended that APRA be given a general standards making power that would cover prudential standards as well as for other areas. The key reasons outlined in the Review in favour of such an approach were that:

- it would allow for a focus on areas broader than prudential issues, such as efficiency and outcomes, to be given the force of law rather than as guidance and
- standards can be made and varied more quickly than regulations which mean that, if required, the law can be quickly adjusted to respond to developments in the industry.  

**APRA’s discussion paper and draft prudential standards**

On 28 September 2011, APRA released a discussion paper outlining APRA’s proposed approach and prudential standards under the proposed standards-making power. Submissions on the proposals in the discussion paper were due by 23 December 2011.

On 27 April 2012, APRA released its response to submissions on the implementation of prudential standards for the superannuation industry. APRA noted that submissions:

[Are] unanimously supportive of APRA’s objectives and the broad direction of the proposed prudential standards, including the range of topics that the prudential standards will cover.

There were many issues raised in submissions regarding the details of the proposals. Areas that attracted a significant number of submissions were proposals relating to the operational risk financial requirement, governance, investment governance and defined benefit matters.

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Key provisions

Item 1 inserts proposed Part 3A which provides the power for APRA to determine prudential standards that must be complied with by certain categories of superannuation funds, licensees of superannuation funds and connected entities of licensees of superannuation funds. Proposed subsection 34C(4) defines the term ‘prudential matter’ to cover a broad range of matters, including the standard of conduct of licensees of the affairs of a superannuation fund and connected entities, the appointment of auditors or actuaries and the conduct of audits.

Determinations made by APRA are disallowable instruments (proposed subsection 34C(10)), except those set out in proposed paragraph 34C(9).

Proposed section 34E requires that if APRA determines, varies or revokes a prudential standard applying to one or more specified RSE licensees or one or more specified connected entities, it must give notice to the effected entities.

Concluding comments

The Bill proposes specific measures related to the governance of MySuper default superannuation arrangements and broader governance-related superannuation funds matters relating to the obligations of superannuation trustees and for APRA to be given a general standards making power. Most of the proposals in the Bill are consistent with those made by the Cooper Review.
Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012

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