▪ PHILLIPS FOX ▪

ACTUARIES & CONSULTANTS

9 May 2001

Mr John Cosgrove
Commissioner
Canberra
L3 Nature Conservation House
Cnr Emu Bank & Benjamin Way
Belconnen ACT 2617

Attention: John Papadimitriou

Review of the *Superannuation Industry (Supervision) Act 1993* and certain other Superannuation Legislation.

Dear Commissioner,

Phillips Fox is pleased to make this submission to the above inquiry.

We begin by stating that Australia has an excellent record in the management of regulated superannuation funds. The number of cases of fraud and dishonesty has been low and members of most funds have received excellent real rates of return over the last decade. Furthermore, levels of disclosure of fees and commissions will be much stronger under the proposed Financial Services Reform (FSR) Act.

It is true that there have been some unfortunate instances, such as the Commercial Nominees fiasco. Fortunately, the absolute amount of funds lost by members through negligence has been relatively small to date.

However, it is also true that the market place has changed since SIS was introduced. Many large corporate funds are converting to public-offer arrangements and there has been a significant growth in small self-managed funds.

Therefore, it is opportune to review the system as there are a number of changes that could be made to improve competition and efficiency. This could lead to a reduction in costs without impairing member security. Our submission focuses on some of these areas.

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1 Is the Trustee role still appropriate?

In our opinion, trusteeship is appropriate where the fund is a "not-for-profit" arrangement and where there is employer/employee representation. Industry funds, corporate funds and public sector funds fall into the category.

However, the existing relationships in many public-offer funds are unusual. The legal relationship is a contractual one between employer and financial institution, yet the trustee has a fiduciary and regulatory role with members.

Is the trustee model still appropriate for public-offer superannuation funds? In the case of those public-offer funds promoted by financial institutions with a profit motive, could we not consider the concept of a Single Responsible Entity (SRE)? This recognises that a public trustee adds no value to the security of members who have money with regulated financial institutions.

It can be argued that a Board of trustees in these situations is unnecessary. The financial institution is already regulated by APRA (and ASIC) and there is usually a contractual arrangement between the institution and the member and/or the employer. Furthermore, the Board in these cases tends to comprise executives of the institution, so the individuals cannot be independent.

Therefore, where the trustee is a wholly owned subsidiary of a financial institution and there is no representation by members, little is achieved by the added expense of the trusteeship. It may even cause members to believe they are receiving a level of duty that is not necessarily there. Clearly, there is a fundamental conflict where associated entities of the trustee are acting for profit.

There are some public-offer funds that have a profit motive but are not managed by financial institutions. The promoter could be a firm of accountants, actuaries or financial planners. In these cases, the financial strength of the organisation is likely to be lower then for a financial institution. APRA should take this into account in setting solvency standards and in imposing business conditions on the organisation. However, a trustee would not be required if these conditions were acceptable and if a custodian were properly appointed.

In contrast, non-profit funds appear to operate successfully under the current trustee model. We do not consider that this model should be changed at this time, but trustee education should be encouraged and supported by government. It is vital to ensure that the trustee directors are knowledgeable.

Finally, the Committee should also look at the role of *policy committees* for master trusts. These are rarely operated and are often considered to be a burden by the financial institution and employer. They have no real power as the trustee need not act on their recommendations. However, these committees perform a vital role in representing the employer group and its numbers. Their role and power should be reviewed.

2 Consistency between Regulators

The outcome of the *Wallis Inquiry* was that Australia would have two regulators over all financial products and services. ASIC would look after market conduct and APRA would regulate financial security. This has largely occurred, and will be reinforced with the introduction of the FSR Act shortly.

However, we now have a separate regulator for small self-managed funds, which are governed by the ATO rather than APRA. This decision has been made in recognition that members who are their own trustees do not need the same levels of consumer protection as those whose funds are held in trust at arm's length.

While there are some advantages in this decision, it does mean that there are different standards applied to members. One of these areas is that of setting *investment strategies* and this is discussed below.

The plethora of new legislation (including the forthcoming FSR Act) means that there may be overlapping legislation. This should also be reviewed[1].

3 Investment strategies

True to Label

Some members have lost money due to inappropriate investments made by the fund. For example, one of the issues with the Commercial Nominees situation was the investing of its enhanced cash fund into illiquid non-performing mushroom farms.

We consider that greater care needs to be taken in ensuring that investment options are *true to label*. If members invest in a cash fund, they have an expectation of capital security – and appropriate assets are required. Although effective disclosure and informed decision making will help, the trustee and/or regulator should also monitor these situations.

Consistency for strategies

APRA is concerned about members making their own (*member-directed)* investment decisions. As a result, members in a master trust or industry fund are not allowed to direct investment strategy, though they may have a limited (or broad) investment choice. Conversely, members of a small self-managed fund can set their own strategies. For example, they could develop their own share portfolio, whereas members of a master trust cannot invest directly in shares.

[1] As an example, there are various false and misleading provisions of Parts 18 and Part 19 of the SIS which are more than covered by the standard false and misleading provisions that now appear in Division 2 of Part 2 of the ASIC Act. The inconsistent provisions should be repealed.

We would argue that it is inefficient for the ATO and APRA to have different rules for investment strategies. One consequence of this is that members with large accumulations who want to invest directly in shares are required to set up their own fund. This is one of the reasons for the growth in small self-managed funds in recent years.

APRA is not consistent in setting guidelines for investment strategies. A member of a master trust with $300,000 is not allowed to invest in individual shares. Yet members of some industry funds, with APRA permission, can invest all of their account balance into Coles Myer shares in order to receive retail discounts as share-holders (even though the shares are legally held in the name of the trustee).

Default investment strategies

Another area of concern is that of default funds. When a company joins a master trust or industry fund, it is common to choose one investment option from the list available. This becomes the default fund for members who do not make an election.

Many of these funds are chosen conservatively – so as to minimise capital losses. Unfortunately, this type of selection is likely to *reduce* long-term earnings and is inappropriate for members remaining in a fund on an ongoing basis. While it is true to argue that members can opt out, they often trust the employer to have made a decision that is in their best interests. Consequently, many members do not make an active decision. This could reduce their long-term returns in some cases.

We consider that current policy (including APRA guidelines) relating to investment strategies should be reviewed.

4 Successor Fund Transfers

In order to facilitate the wind-up of a fund or the transfer of an employee group from a poorly performing fund, SIS includes *successor fund* provisions. These permit an employer to transfer all employee members in bulk without requiring member consent.

There are a number of conditions attached to a successor fund transfer, but there is a difference of opinion about the interpretation of some of these. Since the trustees of the two funds both have to agree, there can be significant delays in the transfer from one public-offer fund to another while the current trustee obtains legal advice (at the employer's expense). We have encountered cases where the transfer has taken six months due to this tortuous process.

Better guidelines for successor fund transfers are needed.

5 Enforceability of contributions

The Committee should examine the role of the three tiers of contributions and more importantly, their fundamental unenforceability. Trustees often have no legal right to collect contributions that are in arrears[2].

We act for various funds and, on occasion, review the continuing problem of trustees having no enforceable rights to recover amounts that the member would expect to be paid.

The trustee will only have enforceable rights if it has a contractual right against the employer. As there is no consideration moving between the trustee and the employer, the only way a contractual entitlement can be created is by deed. However, employees have no obligation to sign such a deed.

Even where the original employer did sign such a deed, businesses are sold and change structure and the subsequent employers will not necessarily sign a deed. The trustee has no means of knowing there has been a change in ownership.

In case of awards, the trustee has no standing to take any action.

In case of SG, any payments to a fund are purely voluntary payments made to satisfy a tax obligation, unless the employer chooses to contract with the employee to make these benefits. Again the trustee has no standing to take action.

6 Disclosure

One of the key elements of superannuation is to allow the easy enrolment of large numbers of members receiving small contributions into superannuation funds (particularly industry funds) without expensive enrolment procedures and documentation. Often the whereabouts of the member is not known and will not be known until the member claims payment.

The FSR Bill fails to recognise this. It imposes an absolute obligation to provide documentation within three months of enrolment. This is difficult to achieve where the prime communication is with the employer, not the members.

[2] Paragraph 3.14 of the Senate Select Committee on Superannuation Financial Services report of April 2000 refers to some previous press reports that commented on the problems of enforceability.

Any redesign of the system needs to be mindful of the potential increased cost of enrolment procedures, and not maximise disclosure requirements having no regard to compulsory obligations and the reluctance of people to provide sufficient information to communicate with them (until they want payment).

Yours sincerely,

Michael J Rice
Managing Director

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