

CORPORATE SUPER ASSOCIATION

SUBMISSION TO

TREASURY

ON

***SUPERANNUATION SAFETY AMENDMENT BILL 2003 (EXPOSURE
DRAFT)***

JULY 2003

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1 BACKGROUND

1.1 The Corporate Super Association

The Corporate Super Association is Australia's representative body for major Not For Profit corporate superannuation funds and their corporate sponsors.

The assets of Association members amount to approximately \$55 billion, representing about 85% of total corporate superannuation sector assets in Australia and some 750,000 individual employee fund members.

1.2 Abbreviations used in this submission

The Association	The Corporate Super Association
The Draft Bill	Exposure Draft: Superannuation Safety Amendment Bill 2003
SIS Act, SIS legislation	Superannuation Industry (Supervision) Act 1993, and related legislation

1.3 Context of submission

The Treasurer has issued the Draft Bill for public comment and consultation. Our Association has participated in the Round Table industry discussion of the Draft Bill on 13 June 2003 and has provided comments in this paper on matters relating to the Draft Bill raised at that meeting.

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2 SUMMARY

We wish to comment on the following areas:

- corporate governance in general; and
- the following areas specific to the Draft Bill:
 - categories of licence;
 - trustee qualifications;
 - licence fees;
 - tax relief in the event of fund merger resulting from the Draft Bill's proposals; and
 - other issues.

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3 CORPORATE GOVERNANCE

The corporate governance model *par excellence* is the trustee board of an employer sponsored Not For Profit fund, where there is equal representation by members and employer representatives and where there is undivided focus on carrying out the fiduciary duty to protect the interests of members. By contrast, the governance model of a For Profit trustee board is a weaker model where the fiduciary duty may be compromised by commercial imperatives to earn profit for the trustee.

Trustees of public offer funds. The trustee of a public offer entity will operate differently from that the trustee of a standard employer sponsored fund, because of its different composition (generally, absence of equal representation) and the imperative, in most cases, to generate profits for the trustee's owners. Interests in public offer funds are generally marketed and issued as financial products with the prime objective of realising profit for the issuer's shareholders. These service providers and their agents have a financial interest in drawing additional funds under management. They have no connection, other than commercial, with either the sponsor or the members.

Trustees of Not For Profit employer sponsored superannuation funds. The main reason for the existence of these funds is a concern on the part of the employer sponsor to provide for the welfare of employees and their dependants through appropriate incentive and benefit structures. There is no profit motive or commercial interest in bringing funds under management. The governing trustee bodies are required to represent the best interests of individual employees.

The trustee bodies of these entities can be distinguished between those which act in the capacity of "professional" or commercial trustee, i.e. a trustee for hire for those funds who wish to outsource that function; and those bodies made up of representatives of employer and employees.

In the outsourced professional trustee model, employers and employees lose legal control over the trustee. More serious, from a corporate governance point of view, is that where entities connected to the commercial trustee are in turn also potential service providers to the trustee, then the objectivity of the trustee board may be seriously compromised and potential conflicts of interest may become apparent.

Whilst there are arguments for leaving the trustee function to the specialists, there is significant strength in the arrangement where the trustee function is not outsourced and the trustee body is made up of representatives of the employer and the members, subject to the operation of the equal representation rules. In this case, the trustee body does not obtain profit, nor is there a dividend payable to shareholders of the trustee body. Consumer protection in these entities is, to a major extent, inbuilt through the extensive cooperative involvement of employers and members in the governance of the funds.

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We believe that this is a governance model which benefits from the diversity of perspectives brought to the table by the employer and employee representatives. Whilst there may be efficiencies in using trustee bodies made up of specialists in administering and advising funds, we believe that these efficiencies may be countered by some increase in risk. Risks may arise from the absence in members of the trustee body of diversity of perspective, from absence of familiarity with the industry or environment served by the fund, and lack of other skills which could be gained from participation in a non-financial environment. There is an argument in favour of including in trustee bodies those without specialist skill who can ask questions which would not be raised by specialists – and which should be raised. That is to say, specialists can suffer from an inability to discern larger issues and to step back and evaluate. They may make assumptions or take matters for granted which should be questioned. And, probably most important of all, they do not have the specific personal concern and desire to make things work which is the great benefit arising from involvement of members and employer representatives.

We believe that, in a well-run fund with sufficient resources and care devoted its in-house trustee function, the risk associated with using non-specialist trustees is amply compensated for by the benefits of using a trustee which is intimately acquainted with the fund, its members and with the business in which the employer-sponsor operates.

By contrast, we are of the view that a commercial trustee, operating in the capacity of trustee for a number and variety of different funds, is exposed to a greater variety of risks than the trustee body which operates as the trustee for one fund only. These risks arise from a variety of reasons. For example the trustee needs:

- adequacy and sufficient diversity of resources to service the number and variety of funds serviced;
- knowledge of the industry in which each particular fund operates and the needs of the members;
- a full understanding of the structure and benefits provided by each fund served; and
- an ability to erect Chinese walls between the various entities it serves and between the trustee function and any other functions it performs.

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4 SPECIFIC ISSUES

4.1 *Categories of licence*

Proposed section 29B of the SIS Act would provide for classes of trustee licences, which may not be mutually exclusive. The draft Bill provides for one specific class, that applicable to public offer entities, and leaves scope for other classes to be provided for in regulations.

We wish to state in the first instance that our Association has been and remains opposed to the concept of APRA licensing for large Not For Profit funds using trustees established under SIS Act provisions with equal representation. This opposition is grounded on our confidence in the trustee governance model in funds where employers and members are represented on the trustee board. Those who are supporting and those who will benefit from the fund are cooperating in overseeing the major decisions in running it. The current provisions of the SIS Act are, in our view, sufficient to ensure safety of the large Not For Profit employer-sponsored funds.

However, we note the Government's policy approach that there must be a universal APRA licensing regime. In this context, we would support an approach involving classes of licence reflecting the degree and type of governance risk associated with the particular trustee.

4.1.1 Trustee risk

We believe that trustee risk is related to:

- the types of superannuation entity for which the trustee acts; and
- the resources available to the trustee to perform its tasks.

It is important to note that where the trustee acts for a defined benefit fund there is a transfer of a substantial element of risk to the employer sponsor, which generally bears the investment risk and other risks associated with ensuring that benefits are provided. This contrasts with the situation in a defined contribution fund, where such risks rest with the fund trustee. We believe that this risk transfer from trustee to employer should be recognised.

Apart from the above point, there is an increasing level of complexity, and hence potential risk, associated with acting as trustee:

- of one fund with many participating employers;
- of more than one fund, particularly where the sponsors are not related and/or do not participate in the same activity or industry; or
- of one fund which is a public offer fund and which therefore accepts contributions from a wide number of sources.

Further, if the trustee does not have access to sufficient resources to carry out its task, there is increased risk.

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A lack of resources could include:

- lack of physical resources;
- lack of skill, knowledge or experience available to the trustee body (note that the skills do not need to reside in the trustees themselves, and that they can be provided by external parties if appropriately controlled by the trustee); or
- lack of interest in or focus on the trustee tasks and functions, on the part of the trustee.

Availability of resources and skills:

The first two difficulties listed above are more commonly a concern in the trustees of smaller funds. For example, APRA has reported particular regulatory difficulties with small funds, particularly those with under \$1 million in assets, notably:

- concerns regarding appropriateness of investment decisions, and related party transactions; and
- breaches of reporting requirements and concerns with the robustness of reporting and administration systems¹.

Such difficulties arguably stem from resourcing problems .

Failure of trustee focus:

We would categorise the difficulties of various publicly offered entities (e.g. the Commercial Nominees group) under this heading. Trustees may become distracted and lose sight of the primary concern (safeguarding assets for the benefit of fund members). Close connection of the trustee with, and interest in the marketing of specific products, may give rise to inappropriate decisions regarding the investment of the funds of which they act as trustees².

4.1.2 Classes of licence

We believe that the classes of licence under the legislation should reflect the following:

- a distinction based on governance risk. We perceive a lower governance risk in trustees comprising employer and employee representatives. Trustees of public offer funds, and trustees operating as professional service providers, experience a higher level of governance risk; and
- a distinction based on the structure of benefits in the fund. Where the fund is a defined benefit fund, the financial strength of the employer sponsor should be taken into account, as arguably the strength of the employer-sponsor becomes an element in assessing risk for the fund.

¹ Senate Select Committee on Superannuation and Financial Services: Paragraph 3.25 in “Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services: First Report”, issued in August 2001.

² Senate Select Committee on Superannuation and Financial Services: “Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services: Second Report – Some Case Studies”, August 2001.

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We believe that the grant of a licence should depend on an assessment by the regulator that there are adequate resources applied in running the trustee function and in operating the fund. It should be accepted that these resources and skills can be outsourced provided that they are well controlled by the trustee.

We have heard views that licence classes should also distinguish between funds with limited classes of investments such as managed investments only, and those whose investment strategies permit a broader spread of investments. We are not convinced that the restriction of the investment strategy of a fund to limited classes will assist in reducing risk (other than in a fund with limited assets and limited resources for making informed investment decisions). In general, in a fund of any significant size, we understand that there is a conventional view among investment specialists that diversification of classes of investments leads to an overall reduction in investment risk. We believe that the main criteria in assessing the governance risk for a trustee should be the appropriateness and integrity of the resources applied by the trustee in making decisions and formulating its strategies.

4.1.3 Recommendation

We propose the following classes of trustee licence:

1. Trustee of one or more public offer fund;
2. Trustee operating for a fee as trustee of funds with which the trustee has no connection (Approved trustee/professional trustee);
3. Trustee (made up of member and employer representatives) of Not For Profit fund(s) where the resources and support applied are appropriate to the trustee's task;
4. Trustee of Not For Profit fund as above, but where the majority of the benefits are defined benefits.

The licence conditions should reflect the level of governance risk applicable to each category. We maintain that categories 3 and 4 experience reduced risk because of the superior nature of the governance model and the generally high level of resources applied to supporting the trustee. We believe that where there are defined benefits, trustee risk is further diminished because of the involvement of the employer sponsor in supporting the fund throughout the period of benefit provision. This reduces financial risk for the trustee and is often accompanied by significant support in the form of resources provided by the employer.

We suggest that where there are particular risks that trustee resources may not be adequate to the tasks it faces, special conditions should be imposed on the trustee's licence. Where the resources are clearly inadequate to the trustee's task, the licence should be withheld.

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4.2 Trustee qualifications

We understand from the discussion at the Round Table meeting on 13 June 2003 that the intention is that the proposed standards relating to “fitness and propriety” of licensed trustees and groups of individual trustees referred to in section 29D at paragraph (d) should not be significantly more restrictive, in relation to individual trustees and directors, than the current requirements under the SIS Act which exclude trustees with serious criminal histories.

As indicated at Section 3 (“Background remarks: trustee function”) above, we believe that there is great value in the equal representation model and that this has significant governance strengths. We would be concerned if a desire to ensure that measurable formal skills were displayed by all members of a trustee board resulted in the exclusion from involvement in the trustee function of individuals without formal financial and management training, but with significant employment and life skills and motivation to contribute to the fiduciary role.

We accept that there is merit in requiring that appropriate formal training should be provided for incoming members of trustee bodies. However, we believe that any training requirements should acknowledge that the role of the trustee board will involve significant delegation to experts, with the result that the skills which trustee may most need are those in managing and monitoring the work of others. We believe that the decision regarding what is appropriate training will depend on the circumstances of the fund. The trustee body of each fund will be aware of the training suitable to its circumstances and should have a primary role in determining the areas to be covered.

4.3 Licence fee and regulatory fee structure

We understand that fees for licence applications have yet to be set. We would like to place on record our concern that the fee structure should not operate as a barrier to entry to all but the very largest players. We acknowledge that it may be in the interests of the industry and of fund members that very small funds with high level of risk should merge. However, we wish to avoid a situation where the industry becomes dominated by a few players with very large resources at their disposal. The setting of very high licence fees would favour this situation. This would not necessarily be in the best interests of fund members who are well served by employer-sponsored Not For Profit funds where the returns tend to be higher and the fees and commissions lower than in retail funds³. In any policy approach to rationalising the market, a balance needs to be struck between reducing the number of players and reducing regulatory complexity, and eliminating entities which are performing a worthwhile function and providing competitive or better than average benefits to their members. To lose the latter would actually increase public costs in the future (even if it reduces market diversity, and hence regulatory complexity, in the short term).

³ *The Investment Performance of Australian Superannuation Funds*, Anthony D. F. Coleman, Neil Esho and Michelle Wong, Working Paper 2003-02 Australian Prudential Regulation Authority, February 2003

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4.4 Tax relief for fund mergers

We believe that it is desirable that where legislation, such as the current Draft Bill, is introduced which is likely to result in significant rationalisation of the market, there should be relief offered to those funds which find themselves compelled to merge. In the absence of capital gains tax rollover relief for mergers which occur as a result of the proposed legislation, unrealised gains will be deemed to have been realised when a fund merges into another fund.

When the SIS Act first came into force in 1994, CGT relief was provided under the ITAA 1936 for funds which merged during a transitional period, provided that all the assets which were transferred into the new fund supported liabilities which had been newly assumed by the new trustee. This legislation ceased to apply for mergers after 30 June 1997.

We understand that the CGT provisions under the ITAA 1997 may be interpreted to exclude from the definition of “CGT event” situations where trust assets (assets of Trust 1) are transferred to and merged with the assets in another existing trust (Trust 2) and where the terms under which the transferred assets are held in Trust 2 are essentially the same as in Trust 1. This would be a possible interpretation of subsection 104-60(5), paragraph (b). We believe that there is some uncertainty as to whether the ATO would accept that this exception would apply in fund merger situations, because of the existence in the Trust 2 of other assets and other trust interests apart from those of the Trust 1. It would greatly assist any merging funds if either some transitional relief were legislated or, alternatively, if the ATO were willing to issue a legislative interpretation or ruling on which merging funds could rely stating that such relief would be available under existing legislation.

4.5 Other issues relating to the draft bill

The following issues have been raised by our members.

Co-operation between ASIC & APRA

There is a possibility that APRA could deny a license to a trustee who was licensed under FSR. We suggest that it would be appropriate for APRA to inform ASIC of any pending denial of APRA licensing.

Increase in APRA powers

We would support the inclusion of appeal mechanisms in respect of APRA decisions to remove trustees and suspend licences.

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90 day deadline for APRA response under section 29CB

Under subsection 29CB(4), if APRA fails to meet the 90 day deadline then the application for the licence is deemed to fail. We are concerned that the trustee would be penalised as a result of a delay in APRA response, and suggest substitution of a requirement that APRA either respond within the time limit or indicate a date by which a response will be available.

A similar issue arises in relation to section 29MB.

Section 29DC: Documents required to bear licence number; section 29NB: documents required to bear registration numbers

Trustees are required to produce a Product Disclosure statement for FSR by March 2004. This requires time, effort and expense to print. It appears trustees will then need to reprint this when they receive a license number and the fund's registration number. It is suggested that relief from the requirement to display the licence and registration numbers be provided for an appropriate transitional period: e.g. the currency of the PDS in force when the legislation commences.

Suspension or removal of trustees of superannuation entities

Paragraph 133 (1) (c) appears to permit APRA to remove or suspend a trustee where there is non-compliance with operating standards (set by APRA), without review. We are concerned that this can occur for any breach of operating standards and we are also concerned about the lack of a review facility.

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5 RECOMMENDATIONS

We would support the following:

- Adoption of classes of licence related to the risk profile of the trustee, as reflected in the type of funds the trustee serves, the resources available to the trustee and their appropriateness to the task the trustee faces.

Accordingly, we would support the following classes of trustee licence:

1. Trustee of one or more public offer fund;
2. Trustee operating for a fee as trustee of funds with which the trustee has no connection (Approved trustee/professional trustee);
3. Trustee (made up of member and employer representatives) of Not For Profit fund(s) where the resources and support applied are appropriate to the trustee's task;
4. Trustee of Not For Profit fund as above, but where the majority of the benefits are defined benefits.

Licence conditions should reflect the risk inherent in the above classes. In our view, categories 3 and 4 are the least risky because of the superior nature of the Not For Profit governance model.

- Recognition of the value of the equal representation model for trustees of Not For Profit funds, and the avoidance of requirements for formal qualifications for such trustees.
- Setting of licence application fees at a level which does not act as a significant barrier to entry.
- Availability of capital gains tax relief for funds forced to merge as a result of the proposed legislation.