Law Council
OF AUSTRALIA

Exposure Draft – Intra-fund Consolidation of Superannuation Interest

The Treasury

Submission by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia

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The re-issued exposure draft of *Superannuation Legislation Amendment (Stronger Super and Other Measures) Bill (No 2) 2012: Intra-fund consolidation of superannuation interests* has been reviewed by the Superannuation Committee (the Committee) of the Legal Practice Section of the Law Council of Australia. There are two points which the Committee wishes to make at the outset.

First, the Committee appreciates being contacted directly by Treasury and invited to provide further comments, as it was on this occasion, especially given the limited time frame. The Committee welcomes any opportunity to consult directly with you, especially in relation to drafting points where Treasury may be aided by the expertise and experience of the Committee.

Secondly, the re-issued exposure draft is a completely new document that bears little resemblance (if any) to the original exposure draft. It will be a challenge for industry to identify all potential issues in the four business days which have been allowed for submissions. Given the new drafting, it appears that several of the issues identified in the Committee's original submission no longer arise. That said, several new issues now arise and require attention.

The key issues which have been identified are as follows.

1. The original exposure draft imposed a strict obligation to consolidate accounts, which was inflexible and prescriptive as to the manner in which consolidations were to be implemented. This approach would have required modifications to allow carve-outs and flexibility in appropriate cases. However, there was a clear and certain obligation to consolidate accounts and a relatively 'safe harbour' for trustees in cases where accounts were in fact consolidated.

   Under the new exposure draft, there is no clear obligation to consolidate, but rather a conditional obligation to do so which will be open to challenge regardless of which way a trustee moves in a particular case.

   If a trustee decides to consolidate accounts, it could be criticised for doing so (for example, because the member disputes that consolidation was in their best interests). On the other hand, if a trustee decides not to consolidate accounts in a particular case, they would equally be at risk of being criticised by both the member and the regulator if, for example, either the member or the regulator is of the view that the best interests of the member required consolidation. It is unsatisfactory for a proposed new law to put trustees in such a position.

2. The drafting of the new exposure draft seems to assume that a trustee will be protected so long as it is acting in the best interests of the member, but this is not correct. There is a long line of case law which makes it clear that a trustee cannot simply do whatever it wishes simply on the basis that the trustee is purporting to act in the best interests of members. A trustee's paramount duty is to comply with the trust deed and a trustee cannot take action which it lacks the power to undertake, even if doing so would be in the best interests of members.

   That said, in practical terms, many modern trust deeds (but not necessarily all) contain provisions which permit the trustee to take action where the trustee is 'required' (as opposed to 'permitted') by relevant law to do so.

3. For the reasons set out at paragraphs 1 and 2 above, there are compelling legal reasons why the legislation should:

(i) impose a clear obligation to consolidate in particular cases (rather than merely requiring the trustee to comply with its own internally developed rules for consolidation); and

(ii) create a statutory 'safe harbour' or statutory defence to protect trustees in cases where accounts are consolidated, especially with regard to any investment losses (or investment opportunity losses) that might be linked to the decision to consolidate.

These are separate points and both should be reflected in the final legislation. The Committee's original submission pointed to the need for a statutory defence, but this concept has not been accommodated. Now that the draft legislation is no longer concerned only with small account balances, there is the potential for consolidation to apply to accounts which have substantial account balances and claims in relation to investment losses could therefore be considerable, especially if the rate of return applicable to the member would have been significantly higher, had their accounts not been consolidated. As such, there is a greater need for a statutory defence than there was under the original exposure draft.

4. The Committee notes (as it has on other occasions in relation to other proposals) that there have been an increasing number of (new) legal requirements in recent years which misconstrue the fiduciary duty to act in the best interests of members. This is a duty to act in the best interests of all the members, as a whole, and is a duty which informs and regulates the manner in which trustees go about making their decisions. It is not a duty which requires a trustee to act in the best interests of any particular member on an individual basis; and indeed it is not a duty to ensure that any particular decision necessarily turns out to be in the best interests of the members or any one of them.

In this case, the proposed section 108A(1)(c) requires the trustee to merge interests "if it is in the best interests of the member to do so". This is an inaccurate reflection of what a trustee's fiduciary obligations include.

Converting the traditional fiduciary duty, which applies generally and non-specifically to members, into a duty which is owed in a specific way to individual members, is a concerning proposal.

Assuming the legislation is to approach the consolidation issue in this way, it would be more appropriate to require trustees to act in the best interests of members when formulating their policies and rules concerning consolidation, rather than requiring trustees to form a view about whether or not consolidation is in the best interests of any particular member.

Along similar lines, it should be noted that the examples provided at paragraphs 1.26 – 1.29 of the revised Explanatory Materials seem to be particularly artificial and would be concerning if they are intended to reflect how trustees are expected to approach the legislation. In practice, where superannuation funds have large numbers of members (possibly in the hundreds of thousands or more), it is highly unlikely that trustees will grapple on an individual basis with the personal situation and circumstances of individual members before consolidating their accounts, which would be akin to forming a view analogous to personal advice. Forming a view that a particular member is "fully engaged" or making judgments about the "potential additional earnings" will be fraught with the risk of challenge by members armed with the benefit of hindsight. Trustees may not be licensed or qualified to

form a view as to which of two strategies is more appropriate for a particular member given their particular situation. In any event, the proposed section 108A(2) does not include these matters (i.e. degree of engagement and potential earnings) amongst the things which might be taken into account when deciding whether or not consolidation is in the best interests of members. Indeed, it is unclear how the level of engagement by a member has any bearing on whether or not consolidation would be in their best interests.

5. At a minimum, draft section 108A(2) should expressly recognise that trustees may have regard to matters beyond those listed in the draft section. The current drafting is solely focussed on the issue of costs and insurance premiums, and does not make provision for investment risk, investment return, scope of insurance cover, amount of insurance cover and the extent of any account activity, including directions by the member, to be taken into account. To be comprehensive about the matter, the section would need to allow trustees to have regard to the range of considerations typically taken into account by a financial adviser before providing personal advice. This highlights the difficulty with this new approach in the draft legislation. Further, any other restrictions on dealing with the member's account should also be recognised, for example, any payment flags under the superannuation legislation which might prevent the trustee from consolidating accounts.

6. Although paragraph 1.5 of the revised Explanatory Materials still suggests that the legislation is intended to reduce the number of "unnecessary and inactive" interests in the superannuation system, there is nothing in the draft legislation which limits its application to inactive accounts. Indeed, the draft legislation would apply as much to necessary and active interests, as it would to unnecessary and inactive interests.

7. This being the case, the legislation should make provision for cases where members elect to have multiple interests in a fund such that the consolidation rules do not apply in those cases. Paragraph 1.15 of the revised Explanatory Materials contemplates that a member may direct the trustee not to merge their interests, but this flexibility is not contemplated by the draft legislation. Indeed, proposed section 108A would seem to require trustees to ignore any 'opt-out' direction given by a member.

8. The proposed section 108A(1)(d) precludes fees being charged for any merger of superannuation interests. To the extent that this is intended to preclude the deduction of lump sum administrative fees for merging interests, the Committee suspects trustees will be able to comply with the spirit of the legislation, subject perhaps to coding the necessary system changes which might otherwise deduct closure fees on an automated basis. However, it does not seem appropriate for the legislation to preclude the imposition of buy/sell spreads or other switching fees in cases where the consolidation results in part of the member's balance being moved from one investment option to another. These charges are typically intended to recover the transaction costs incurred by the trustee in divesting assets in the original option and reinvesting the proceeds in the new option. Even the MySuper legislation allows these charges to be applied to MySuper members and there does not appear to be any reason to preclude the recovery of these costs here. Indeed, it would create a cross-subsidy, which could potentially be significant, given that the legislation is no longer limited to small account balances and could potentially result in very large account balances being consolidated. It would be unfair for the costs of changing the way in which large account balances are invested to be borne by other members, who may in fact have smaller account

balances and for whom such costs could have a disproportionate impact.

9. Paragraph 1.12 of the revised Explanatory Materials suggests that, in cases where consolidation results in there being multiple interests within the one account, there should only be one fixed fee that applies to the account. First, it should be noted that the draft legislation does not impose any such requirement. Secondly, presumably the intention is that there should be no duplication of fixed fees; presumably there would be no objection to there being multiple fixed fees for different types of services, as long as there is no duplication.

10. It is unclear how the legislation is intended to apply in the case of deceased members pending a decision on the release of death benefits.

11. The Committee notes the comment at paragraph 1.17 of the revised Explanatory Materials that it is difficult to define ‘account’ in legal terms and that, for this reason, the draft legislation refers to the consolidation of ‘superannuation interests’. The Committee considers that the term ‘superannuation interest’ should not be used in this context and that it would be preferable to persevere with a definition of ‘account’; while it is not a term of precise legal meaning, it is generally understood. In contrast, ‘superannuation interest’ is defined under section 10 of the Superannuation Industry (Supervision) Act and means ‘a beneficial interest in a superannuation entity’. The question of what is a ‘beneficial interest’ is the subject of a significant body of case law and, while it will in any particular case turn on the trust instrument and context, for the purposes of this legislation, from a legal perspective, a member would most likely ever only have one beneficial interest in a particular entity, and therefore only ever have one superannuation interest. This would be the case irrespective of how many accounts are held by the member.

    As such, an obligation to consolidate superannuation interests (as defined) will be redundant from the outset as a member would never have more than one superannuation interest to consolidate.

    The Committee notes that the Income Tax Assessment Act and Corporations Act both appear to accept that a member of a superannuation fund will have a single beneficial interest in the fund for the purposes of the Superannuation Industry (Supervision) Act and have included specific deeming provisions where, for specific regulatory purposes, there is a need to dissect an interest. For example, the Income Tax Assessment Act deems a member to have a separate “interest” in the fund when they commence a pension for the purposes of applying the proportioning rule and the Corporations Act deems there to be the issue of a new financial product when a member moves from the growth phase to the pension phase or from one sub-plan (as defined) to another.

    For this reason, and in any event, the draft legislation should clarify that pension interests are not required to be consolidated with accumulation interests in the same fund. It would also be preferable to clarify the extent to which trustees may validly refrain from consolidating accounts which, although in the same fund, pertain to different sub-plans and/or different employers, especially in the master trust context.

12. Finally, given the difficulties associated with both the original and the revised exposure drafts, the Committee queries whether alternative approaches to the issue have been considered. It appears that the key concern which is driving this proposal is the duplication of administration fees which arises when members have multiple accounts. If this is the case, it may be preferable to address the

issue of fee duplication in direct terms (which is something the revised exposure draft does not do at all). For example, the legislation might simply require trustees to take reasonable steps to ensure that lump sum fees which are only intended to be borne once by a member in any given period are in fact only borne once by any member in any given period. Trustees could then be afforded flexibility to address the issue by either waiving or rebating the fees or failing that, by being required to consolidate accounts if permitted by the governing rules (and subject to appropriate carve outs).

The Committee would welcome the opportunity to discuss its submission further. In the first instance, please contact the Chair of the Superannuation Committee of the Legal Practice Section of the Law Council of Australia, Heather Gray on (03) 9274 5321 or at heather.gray@dlapiper.com.

Attachment A: Profile of the Law Council of Australia

The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its constituent bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Large Law Firm Group, which are known collectively as the Council's constituent bodies. The Law Council's constituent bodies are:

- Australian Capital Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Independent Bar
- The Large Law Firm Group (LLFG)
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of approximately 56,000 lawyers across Australia.

The Law Council is governed by a board of 17 Directors – one from each of the constituent bodies and six elected Executives. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive, led by the President who serves a 12 month term. The Council's six Executive are nominated and elected by the board of Directors. Members of the 2012 Executive are:

- Ms Catherine Gale, President
- Mr Joe Catanzariti, President-Elect
- Mr Michael Colbran QC, Treasurer
- Mr Duncan McConnel, Executive Member
- Ms Leanne Topfer, Executive Member
- Mr Stuart Westgarth, Executive Member

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